SELECTED FEDERAL TAX LEGISLATION,

CASES & RULINGS

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by

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This article will provide a summary of selected developments in

I. FEDERAL LEGISLATIVE ACTIVITY

Tax Increase Prevention and Reconciliation Act of 2005 (H.R. 4297)

President Bush signed the Tax Increase Prevention and Reconciliation Act of 2005 on May 17, 2006. Of interest to trust and estate attorneys are the following:

1. The Bill extended the 15% maximum capital gains and dividends rates for two years through 2010.

2. Although the Bill increased the alternative minimum tax exemption for individuals, it did not change the $22,500 exemption for estates and trusts.

3. The Bill extended the application of the so-called "kitty tax" so that the tax now applies to a child who is under the age of 18 as opposed to under the age of 14. The "kitty tax" taxes the unearned 4. For tax years beginning after 2009, the Act eliminates the income of minor children at the parent's highest marginal rate.

$100,000 income limitation that currently prevents some taxpayers from converting traditional IRAs to ROTH IRAs. The Act allows the amount that is includable in taxpayer's gross income from a 2010 conversion to be included in income over a two-year period beginning the year after the conversion. This tax break is available for 2010 conversions only.

II. FEDERAL REGULATORY ACTIVITY

A. T.D. 9208, 2005-31 I.R.B. 157 (August 1, 2005)

Amendments to Treas. Reg. §26.2632-1, relating to the procedures for electing out of the automatic allocation of the generation-skipping transfer (GST) tax exemption to indirect skips, have been adopted by the Internal Revenue Service. Under the final regulations, a transferor who wishes to elect out of the automatic allocation rules would have the option of: (1) electing out for the specific transfer to the GST trust; (2) making a single election

that applies to the current transfer and all subsequent transfers made to the trust by that transferor; (3) electing out with respect to only certain designated future transfers; or (4) electing out with respect to all future transfers made by the transferor to any trust, whether or not the trust exists at the time of the election out. In addition, the regulations clarify that an election out of the automatic allocation rules for future years is limited to the automatic allocation rules under I.R.C. §2632(c), relating to indirect skips made during the transferor's life and has no effect on the automatic allocation rules under I.R.C. §2632(e), which apply upon the transferor's death.

B. Rev. Procs. 2005-52 to -59, 2005-34 I.R.B. 412 (August 22, 2005)

The Internal Revenue Service has issued eight (8) new sample charitable remainder unitrust (CRUTS), complete with annotations and alternate provisions in separate revenue procedures. Each sample trust meets the requirements under I.R.C. §664 and Treas. Reg. §1.664-3 for treatment as a charitable remainder unitrust. Six of the eight new revenue procedures supersede one or more earlier ones. The Internal Revenue Service says it will recognize a trust as a qualified charitable remainder unitrust if: (1) the trust operates in a manner consistent with the terms of the trust instrument; (2) the trust is a valid trust under applicable local law; and (3) the trust instrument: (i) is substantially similar to the sample in the particular revenue procedure; or (ii) properly integrates one or more alternatives provisions of the particular revenue procedure in a document substantially similar to the sample.

C. T.D. 9214, 2005-35 I.R.B. 435 (August 29, 2005)

Final regulations under I.R.C. §2651 relating to the predeceased parent rule have been adopted by the Internal Revenue Service. I.R.C. §2651(e) provides an exception to the general rule that a transfer to a grandchild of the transferor is subject to the generation-skipping transfer (GST) tax. Under the predeceased parent rule of I.R.C. §2651(e), if a parent of the transferor's grandchild is a lineal descendant of the transferor and is deceased, the grandchild

is treated as the child of the transferor. The final regulations provide that an individual's interest in property is established at the time the transferor is subject to estate or gift tax. In addition, the regulations specify that an individual will be treated as the member of the generation that is one generation below an adoptive parent for purposes of determining whether a transfer from an adoptive parent to the adopted individual is subject to the GST tax if the individual is: (1) legally adopted by the adoptive parent; (2) a descendant of a parent of the adoptive parent or the adoptive parent's spouse; (3) under the age of eighteen (18) at the time of the adoption; and (4) not adopted primarily for GST tax avoidance purposes based on all the facts and circumstances.

D. Revised Federal Estate Tax Return, Form 706, U.S. Estate (and Generation-Skipping Transfer) Tax Return (Rev. August 2005)

A revised federal estate tax return has been released by the Internal Revenue Service to be used for decedents dying in calendar year 2005. The revised return reflects the following:

1. The maximum rate for decedents dying in 2005 has decreased to 47%.

2. Because the state death tax credit has been phased out for decedents dying in 2005 and replaced with a deduction, the line for "credit for state death taxes" has been removed and a new line 3 added to compute the taxable estate after subtracting the state death tax deduction.

E. Rev. Rul. 2006-26, 2006-22 I.R.B. 939 (May 30, 2006)

The Internal Revenue Service has offered a guidance on whether a surviving spouse has a lifetime interest in an individual retirement account in cases where a marital trust is the IRA beneficiary. The Ruling holds that a surviving spouse would have such a

lifetime interest under specific circumstances, and generally, that the IRA would be treated qualified terminable interest property under IRC §2056(b)(7).

F. Rev. Proc. 2005-70, I.R.B. 979 (November 21, 2005)

The Internal Revenue Service has released its official computation of next year's inflation-based tax figures. Of interest to trust and estate lawyers, are the following:

1. The annual gift tax exclusion rises to $12,000.00 up from $11,000.00 since 2002.

2. The first $120,000.00 of gifts to a non-resident spouse will not be included in the donor's annual amount of taxable gifts, up from $117,000.00.

3. For estates of decedents dying in 2006, the limit on the decrease in value that can result from the use of special valuation will increase to $900,000.00 up from $870,000.00 in 2005.

4. In determining the part of the estate tax that is deferred under I.R.C. §6166 and subject to interest at a rate of 2% per year for decedents dying in 2006, the tentative tax is computed on $1,200,000.00 up from $1,170,000.00 in 2005.

G. IRS News Release 2006-29 (February 16, 2000)

The Internal Revenue Service has revised three forms which will now allow taxpayers to request an automatic six-month extension of time to file federal gift, estate and fiduciary income tax returns. The forms are: Form 4768 for estate tax returns, Form 8892 for gift tax returns and Form 7004 for fiduciary income tax returns.

H. Revised Federal Gift Tax Return, Form 709, U.S. Gift (and Generation-Skipping Transfer) Tax Return (Rev. Jan. 2006)

A revised federal gift tax return has been released by the Internal Revenue Service to be used for reporting gifts made during calendar year 2005. The Internal Revenue

Service has also indicated that Form 709-A, United States Short Form Gift Tax Return, is now obsolete and should not be used.

I. IRS News Release, IR 2006-11 (January 12, 2006)

The Internal Revenue Service has announced the release of a revised Schedule K-1, Beneficiary's Share of Income, Deductions, Credits, etc. (Form 1041) for trusts and estates for 2005. The Internal Revenue Service has indicated that Schedule K-1 has been simplified to reduce common errors and burdens associated with the preparation and filing requirements. The new form can be scanned by Internal Revenue Service employees, which the agency feels will boost accuracy because of fewer transcription errors.

J. Notice 2006-15, 2006-8 I.R.B. 501 (February 21, 2006)

The purpose of this Notice is to extend the June 28, 2005 grandfather date for charitable remainder annuity trusts and charitable remainder unitrusts indefinitely. The Internal Revenue Service said that it will disregard the existence of a spouse's right of election, even without a waiver as described in Rev. Proc. 2005-24, 2005-16 I.R.B. 909 but only if the surviving spouse does not actually exercise the right of election afforded by many states. Previously, the Internal Revenue Service had said that estate planners must obtain waivers whether or not a spouse ever intended to exercise his or her rights for any trust created on or after June 28, 2005.

III. FEDERAL CASES AND RULINGS – ESTATE TAX

A. Definition of Gross Estate (I.R.C. §2031)

1. *A.O.D. 2005-01, Nonacq. 2005-23 I.R.B. (June 6, 2005)*

The Internal Revenue Service has announced that it is not acquiescing in the decision of Estate of Mitchell, 250 F. 3d 696 (9th Cir. 2001), in which the Ninth Circuit Court of Appeals held that the Tax Court erred by failing to require the Internal Revenue Service to

prove the accuracy of its assessment of the value of a decedent's stock. Thus, the Internal Revenue Service feels that the Court of Appeals erred in shifting the burden of proof to the Internal Revenue Service to establish the value of the stock on the basis that the Court felt that the Internal Revenue Service determination of the stock value was arbitrary and excessive.

2. *Estate of Jelke, T.C. Memo 2005-131*

The date of death value of a decedent's interest in a closely-held corporation was calculated by reducing the corporation's value by a built-in capital gains tax liability discounted to reflect when the corporation would reasonably incur the gain and by applying discounts for lack of control and marketability. The Court rejected the estate's valuation based on the assumption of complete liquidation on the valuation date because the decedent's minority interest was insufficient to force liquidation of the corporation and the corporation had no intention to liquidate. The Court agreed with the Internal Revenue Service's computation of the corporation's value based on when the corporation would reasonably incur the capital gains tax liability. The Court then allowed a 10% discount for lack of control and a 15% discount for lack of marketability.

3. *Estate of Maniglia v. Commissioner, T.C. Memo 2005-247*

The entire value of a multi-unit residential rental apartment building rather than just 50% is includable in the decedent's gross estate because the property was not owned by a partnership between the decedent and her son, Joseph S. Maniglia, but rather was owned by a trust of which Joseph S. Maniglia was trustee and decedent was the sole beneficiary. All the relevant documents indicated that the trust owned the property, that the decedent was the sole beneficiary and that her son was the trustee. Neither the filing of partnership returns nor the son's performance of managerial tasks was sufficient evidence that a partnership had been formed.

4. *Estate of Kolczynski v. Commissioner, T.C. Memo 2005-217*

Value of a tract of land owned by a decedent was determined for federal estate tax purposes using the comparable sales approach after consideration of adjustments reflecting the differences between the properties. The Court agreed with the estate's assertion that the tract's highest and best use was recreation supported by selective timber farming because the tract was located in a unique ecosystem and the standing timber's historic use was to assist in covering the property's maintenance expenses. The Court found that a sale of a smaller property contiguous to the decedent's tract, occurring about two years before the decedent's death was relevant. As a result, the value of the decedent's tract was calculated using the comparative sales approach, with adjustments considered for the following:

a. The value of improvements on the properties;

b. The per acre value of the standing timber on the properties;

c. The date of sale of the contiguous property and the valuation date of the decedent's tract;/

d. The per acre sale price of the contiguous property because it was one-fourth (1/4) the size of the decedent's tract; and

e. The location of the properties.

5. *Estate of Kelley v. Commissioner, T.C. Memo 2005-235*

A decedent's interests in a family limited partnership (FLP) and in a limited liability company (LLC) were valued for estate tax purposes using the net asset value methodology and then applying appropriate discounts for minority interest and lack of marketability. The FLP owned assets comprised of cash and certificates of deposit. The LLC was the FLP's general partner holding a 1% interest. Noting that three approaches to measure

the interest in a closely-held entity are commonly used, the Court determined that the net asset value methodology was afforded the greatest weight because the FLP was primarily engaged in investment. The Court then applied a 12% minority interest discount and a 23.5% lack of marketability discount.

6. *Estate of Keller v. United States, 2005 WL 2436461 (S.D. Tex. 2005)*

The Court denied the government's motion for partial summary judgment where plaintiffs based their refund claim primarily upon discounting the value of limited partnership interests allegedly owned by two trusts. The Court held that a motion for summary judgment was not appropriate as to the issues of the proper formation of a limited partnership, whether a management company was authorized to conduct business and whether assets were actually placed in the limited partnerships at issue. The case involves approximately $300,000,000.00 of assets.

7. *Estate of Kahn v. Commissioner*, *125 T.C. No. 11 (2005)*

The value of two individual retirement accounts (IRAs) included in a decedent's gross estate was not reduced by the anticipated income tax liability that would be incurred by the beneficiaries. At the time of her death, the decedent owned two IRAs, one containing marketable securities with a net asset value of $1,400,000.00 and the other marketable securities with a net asset value of $1,220,000.00. Valuing the IRAs for estate tax purposes, the decedent's estate reduced the value of the two IRAs by 21% and 22.5%, respectively, to account for the anticipated income tax liability from the distribution of the IRA assets to the beneficiaries. The Court rejected the arguments advanced by the estate finding that the cases relied upon were distinguishable. The central reason why the comparisons made by the estate failed, according to the Court, was that the hypothetical sale of the securities did not transfer any

built-in tax liability. The Court also observed that I.R.C. §691(c) was designed to provide relief from the double taxation inherent in assets like IRAs.

8. *Anderson v. United States*, *2006 WL 435562 (W.D. La. 2006)*

The fair market value of a decedent's ownership interest in four limited liability companies (LLCs) was determined by using a weighted combination of net asset value and market value approaches. The decedent's estate included minority interest in four LLCs that held mineral interests. The Court ruled that the value of the decedent's interests were to be determined using a combination of net asset and market value approaches with the net asset approach to be weighted two to one over the market approach. In calculating the net asset value, the following adjustments were applied: (1) a liquidation cost of 10%; (2) a ten percent minority discount; and (3) a 40% lack of marketability discount. In calculating the value under the market approach, the Court also allowed a 40% lack of marketability discount.

9. Estate of Trompeter v. Commissioner, 170 Fed.Appx. 484 (9th Cir. 2006)

The Ninth Circuit Court of Appeals has affirmed the Tax Court's judgment relating to the valuation of the decedent's estate in all respects except for its finding that there were 31 additional coins; there was apparently no basis in the evidence for the Tax Court's finding that there were 31 unaccounted for additional coins. However, the Ninth Circuit affirmed the Tax Court's finding of fraud when the executor's of the estate failed to report assets worth over $4,000,000 on the estate tax return and undervalued other assets on the return by a significant amount.

B. Valuation of Certain Farm, etc., Real Property (I.R.C. §2032A)

1. *Rev. Rul. 2005-41, 2005-28 I.R.B. 69 (July 11, 2005)*

The 2005 interest rates to be used in computing the special use value of farm real property for which an election is made under I.R.C. §2032A have been issued by the Internal Revenue Service.

2. *Priv. Ltr. Rul. 200608012 (February 24, 2006)*

The conveyance of water rights and the granting of an easement on property that had been specially valued under I.R.C. §2032A did not constitute a disposition or a cessation of the qualified use for the purposes of the recapture tax except with respect to the portion of properties specifically used for removing ground water. Apparently the majority of the property in question was used as pasture land for raising cattle with a portion dedicated for use as farm land. The properties had never been irrigated and were never expected to be irrigated. However, beneath the properties, a replenishing source of ground water existed. In conjunction with adjacent land owners, the trust that became the owners of the property proposed to lease the ground water rights to a local water authority and to grant an easement that would permit the development and removal of the ground water.

C. Transfers With Retained Life Estate (I.R.C. §2036)

1. *Estate of Tehan v. Commissioner, T.C. Memo 2005-128*

A decedent's estate included the value of a condominium unit that the decedent purportedly transferred to his eight children in a series of fractional interest gifts during the three years preceding his death. The decedent and his children had entered into an agreement that gave the decedent the exclusive right to use and occupy the property with the decedent responsible for paying any mortgage secured by the unit, the monthly condominium dues, the annual real estate taxes, insurance premiums and all costs associated with the maintenance and

repair of the unit. Not surprisingly, the Court noted that the decedent and his children had entered into an express agreement under which the decedent continued to use and occupy the property. Despite the estate's assertion that the agreement was a lease, the Court ruled to the contrary stating the decedent did not agree to pay rent in exchange for living in the unit.

2. *Estate of Strangi v. Commissioner, 417 F. 3d 468 (5TH Cir. 2005)*

The full value of the assets transferred by the decedent to a family limited partnership (FLP) was includable in the decedent's gross estate under I.R.C. §2036. Two months prior to his death, the decedent, assisted by his attorney-in-fact who was also his son-in-law, created a FLP and a corporation to act as the FLP's managing partner. The decedent transferred about $10,000,000 to the FLP, mostly cash and securities, in exchange for a 99% limited partnership interest. After the transfer of the assets to the FLP, various distributions were made to the decedent and his estate with proportional distributions made to the corporate general partner. On remand from the Appellate Court, the Tax Court concluded that the full value of the assets transferred was includable in the decedent's gross estate under I.R.C. §2036(a)(1) and 2036(a)(2). In affirming the Tax Court, the Fifth Circuit held that an implied agreement existed between the decedent and his children that the decedent would retain the enjoyment of the property. This agreement was evidenced by (1) the disbursement of funds by the FLP to meet the needs of the decedent and his estate; (2) the decedent's continued occupation of his residence after it was transferred to the FLP with the accrued rent not paid for over two years; and (3) the decedent's transfer of nearly all of his liquid assets to the FLP which left him with insufficient funds to meet his personal needs. The Court also rejected the estate's argument that the transfer of assets was a bona-fide sale because the transfer did not serve a substantial non-tax purpose.

3. *Tech. Adv. Mem. 200532049 (August 12, 2005)*

The full value of a decedent's residence was included in his gross estate for federal estate tax purposes under I.R.C. §§2036 and 2041 the Internal Revenue Service National Office has ruled. The decedent and his spouse, who predeceased him, executed a deed that conveyed their residence to their daughter. Pursuant to the terms of the deed, the decedent transferred his one-half interest in the residence while retaining a life estate in that interest. When the decedent died, the daughter, as personal representative, retained an attorney who was to prepare a disclaimer of one-half of the residence value on behalf of the decedent. The daughter later filed an action for malpractice alleging that estate tax was imposed because of the failure to execute the disclaimer. The estate ultimately recovered an amount that was equal to the estate tax. The estate filed a claim for refund asserting that only one-half of the value of the residence was properly includable in the decedent's gross estate. Relying on Rev. Rul. 69-577, 1969-2 CB 173 and Rev. Rul. 69-342, 1969-1 CB 221, the Internal Revenue Service concluded that the value of one-half of the interest retained by the decedent pursuant to the deed was includable under I.R.C. §2036. As to the one-half interest conveyed by the decedent's spouse, the Internal Revenue Service ruled that the decedent succeeded to a life estate in the entire property after his wife died and in accordance with the terms of the deed the decedent possessed at the time of his death an unrestricted power to appoint the entire value of the residence for his own purpose. Thus, 50% was includable under I.R.C. §2036(a) and 50% was includable under I.R.C. §2041(a)(2).

4. *Priv. Ltr. Rul. 200548035 (December 2, 2005)*

The appointment of a family-owned trust company as trustee of various family trusts did not cause inclusion of the trust in the gross estates of the respective grantors under I.R.C. §2036 or I.R.C. §2038 or in the estate of any of the beneficiaries under I.R.C.

§2041. Family members formed a trust company as a wholly-owned subsidiary of a corporation to serve as trustee of various family trusts. The corporation's shareholders were family members and trusts and foundations related to the family members. The trust company bylaws provided in part that: (1) discretionary decisions were subject to review by a committee designated by the board of directors or the senior trust officers; (2) at least one board member must be a non-family member; (3) all discretionary decisions must be made by non-family members; and (4) family members who were donors or contingent beneficiaries of an affected trust would be precluded from participating in any discretionary decisions involving the trust. The various trust instruments also contain similar provisions. The Internal Revenue Service ruled that the "firewall" provision in the trust company's bylaws and the trustee provisions in each trust agreement combined to prevent a donor of any trust from having retained dominion and control as required by I.R.C. §2036 or I.R.C. §2038. Similarly, the "firewall" provision and the trustee provisions combined to preclude a beneficiary from having a power of appointment within the meaning of I.R.C. §2041.

5. *Priv. Ltr. Rul. 200602031 (January 13, 2006)*

Division of a trust into two trusts, one of which is terminated by surviving spouse's disclaimer results in inclusion of disclaimed interest in her estate. Apparently, after the decedent's death, the surviving spouse intends to divide a marital trust into two trusts, one trust to contain a parcel of real property over which taxpayer will disclaim. However, the disclaimed property will pass to a charitable trust over which the taxpayer has the right to make final decisions on all issues relating to administration, expenditures and distributions. Furthermore, the disclaimer was apparently not made within nine (9) months of the date of the decedent's death. The Internal Revenue Service has ruled that the property transferred to the charitable trust as result of the purported disclaimed will be included in the taxpayer's estate under I.R.C.

§2036(a)(2). However, the taxpayer's estate will be entitled an estate tax charitable deduction under I.R.C. §2055 for the value of the property that will be included in her estate.

6. *Estate of Disbrow v. Commissioner, T.C. Memo. 2006-34*

The fair market value of a decedent's personal residence that was transferred to a family general partnership created by the decedent, her children and their spouses was includable in her gross estate. The decedent continued to reside in the residence and provided the partnership with funds necessary to maintain the property. The Court concluded that the decedent retained possession or enjoyment of the transferred residence within the meaning of I.R.C. §2036(a)(1) because the decedent and the partnership had an express and an implied agreement that possession or enjoyment of the residence would be for her benefit. The Court observed that the express agreement was found in the lease agreement which gave the decedent the same right to enjoy the property after the transfer as she had before. An implied agreement existed because the partnership was not in a business operated for profit but was merely a testamentary device. Neither the decedent nor the partnership treated the decedent as a tenant to the leased property. The transfer was made when the decedent was almost 72 years old and in poor health and one of the partnership's partners admitted that the donees wanted the decedent to reside in the home for as long as she could. The transfer was made on the advice of counsel in order to minimize estate tax.

7. *Priv. Ltr. Rul. 200606006 (February 10, 2006)*

A grantor's retention of a power to substitute trust assets did not cause the trust property to be included in grantor's gross estate because the power was exercisable only in a fiduciary capacity. The grantor created an irrevocable trust for the lifetime benefit of his spouse, funding the trust with cash and marketable securities. The trust agreement permitted the spouse to withdraw an amount equal to the value of each "qualifying contribution" made to the trust by

the grantor. The grantor had to power to acquire any and all property constituting trust principal by substituting other property of equivalent value measured at the time of substitution. The Internal Revenue Service observed that under the trust agreement the power of substitution could only be exercised in a fiduciary capacity defined as action that was taken in good faith and in the best interest of the trust and its beneficiary.

8. *Priv. Ltr. Rul. 200615025 (April 14, 2006)*

A grantor created trusts A and B. Trust A is irrevocable and primarily benefits grantor's spouse and three children. Trust B is revocable and primarily benefits grantor. During a review of the trust agreements, grantor, his spouse and their attorneys discovered an error in the drafting of trust A. The trust mistakenly provides for a distribution of trust assets on the death of the survivor of the grantor and the spouse to trust B, the revocable trust, rather than distribution under trust A to a family trust. This was a scrivener's error and did not reflect the intentions of the grantor. Consequently, a reformation was allowed without causing includability in the grantor's gross estate under I.R.C. §2036 and related sections.

D. <u>Revocable Transfers (I.R.C. §2038)</u>

1. *Priv. Ltr. Rul. 200523003 (June 10, 2005)*

The appointment of a trust company as trustee of two trusts did not cause inclusion of the trusts in the gross estate of the grantor under I.R.C. §§2036 or 2038 or any of the beneficiaries under I.R.C. §2041. The grantor owned all of the non-voting shares of the trust company while an irrevocable trust that benefited the grantor's lineal descendants owned all of the voting shares. The trust company's bylaws and articles of incorporation precluded the grantor and any of the trust beneficiaries from being a member of a distribution committee with regard to the trust, and provided that not more than one-half of the trust company's directors could be related to or subordinate to the grantor. Moreover, the grantor and his lineal

descendants were not allowed to serve as a trustee of the irrevocable trust. The Internal Revenue Service ruled that because of the combination of the "firewall" provisions in the trust company's bylaws and the trustee provisions in the trust agreements, the grantor was precluded from having the required dominion and control for purposes of I.R.C. §2036 or 2038. In addition, the Internal Revenue Service ruled that the "firewall" provisions and the trustee provisions precluded any beneficiary from having the power to affect the beneficial enjoyment of the property.

2. *Priv. Ltr. Rul. 200531004 (August 5, 2005)*

The appointment as trustee, of a trust company owned by the grantor will not cause the trust to be included in the grantor's estate under I.R.C. §2036 or §2038. This ruling is very similar to the prior ruling and reaches the same conclusion. The trust company has two classes of stock, voting stock owned by an irrevocable trust and non-voting stock owned by the grantor. The trust company's charter provides numerous restrictions on participation in the administration of the trust by the grantor or related parties. The irrevocable trust provides restrictions on the ability of the grantor to direct distributions.

3. *Priv. Ltr. Ruls. 200603040 (January 20, 2006) and 200606006 (February 10, 2006)*

Both of these rulings hold that the retention of power to substitute trust assets does not make the trust includable in the grantor's estate and that exercise of the power will not constitute a gift by the grantor to the trust. Under the terms of the trust, the grantor may acquire any or all of the trust principal by substituting other property of equivalent value. The value is measured at the time of the substitution. The grantor's power to acquire trust property may be exercised only in a fiduciary capacity and for purposes of this power, action in a fiduciary capacity is defined as action that is undertaken in good faith in the best interest of the trust and its beneficiaries and subject to fiduciary standards imposed by applicable state law.

The Internal Revenue Service pointed out that Estate of Jordahl v. Commissioner, 65 T.C. 92 (1975) held that a power to substitute trust property for other property of equal value was not a power to alter or revoke the trust within the meaning of I.R.C. §2038 because the power was exercisable only in good faith and subject to fiduciary standards. Consequently, the Internal Revenue Service ruled that the grantor's exercise of the power of substitution will not constitute a gift to the trust or retention of an impermissible power under I.R.C. §2038.

E. Annuities (I.R.C. §2039)

Sherrell v. United States, 415 F.Supp.2d 953 (N.D. Ind. 2006)

A U.S. District Court in Indiana has held that a decedent's gross estate included the value of an individual retirement account (IRA) created from the roll-over of funds received under a lump sum distribution from an employer pension plan when the decedent retired. When the decedent retired on October 1, 1981, he elected to receive a lump sum payment from his employer which he rolled over into an IRA. Beginning in January of 1983 and until his death in 1999, the decedent received $1,000 per month from the IRA. Noting that I.R.C. §2039 was frequently amended during the period at issue, the Court established that effective for a decedent dying after December 31, 1984, annuities related to individual retirement accounts generally did not qualify for the $100,000 exclusion from a gross estate for estate tax purposes. The transition rules did provide for a grandfathered application of the $100,000 exclusion to estates of decedents who (1) were in pay status in December 31, 1984; and (2) irrevocably elected the form of retirement before July 18, 1984. The Court concluded that the exclusion applied only to qualified plans and specifically did not apply to IRAs; therefore, the transition rule had to be satisfied and although the decedent was in pay status, he had not irrevocably elected the form of benefit. Accordingly, the transition rules of the Tax Reform Act of 1984 did not apply and the proceeds were includable.

F. Powers of Appointment (I.R.C. §2041)

1. *Priv. Ltr. Rul. 200530020 (July 29, 2005)*

The trustee beneficiary did not possess a general power of appointment over a trust created by her deceased husband for her lifetime benefit because of the enactment of a state statute that limited her ability to make discretionary distributions. When the decedent died, his will created a trust benefiting his spouse and descendants, appointing the spouse trustee and giving the trustee absolute discretion to make distribution of trust income to any of the beneficiaries. In 1995 a state statute was enacted providing that a trustee beneficiary can only make discretionary distributions for the benefit of the trustee for health, maintenance, education and support. The statute applied to all irrevocable trusts existing on July 7, 1995. The Internal Revenue Service noted that prior to the enactment of the statute, the spouse's power to distribute was a general power of appointment. However, the enactment of the statute limited that spouse's invasion power by an ascertainable standard.

2. *Priv. Ltr. Rul. 200535009 (September 2, 2005)*

A beneficiary's exercise of her testamentary power of appointment over trust assets did not result in the inclusion of the trust property in the beneficiary's gross estate under I.R.C. §2041. When the beneficiary's grandmother died, her will created a trust for the beneficiary's benefit. Pursuant to the terms of the trust, the beneficiary was given a testamentary power of appointment over the trust property which could not be exercised in favor of the beneficiary, her creditors, her estate or the creditors of her estate. The beneficiary intends to exercise her testamentary power of appointment by making cash distributions from her trust to her children and providing for the remainder of the trust property to be held in trust for the benefit of the beneficiary's children and later descendants. The Internal Revenue Service ruled that because the beneficiary could not exercise the power in favor of herself, her creditors, her

estate or the creditors of her estate, the power was not a general power as defined in I.R.C. §2041(b)(1). The Internal Revenue Service also concluded that the limited powers of appointment created by the beneficiary could not be exercised in a manner that postponed or suspended the vesting of the trust property for a period extending beyond the applicable perpetuities period. As a consequence, I.R.C. §2041(a)(3) did not apply.

3. *Priv. Ltr. Rul. 200604028 (January 27, 2006)*

The estate and gift tax consequences of a proposed reformation of a couple's revocable living trust and the husband's will in the event that the husband predeceased the wife were determined. After the proposed reformation of the wife's trust, if the husband predeceased the wife, he would have a testamentary general power of appointment equal to the amount of his remaining applicable exclusion amount. Following the husband's death, if the wife survives him, she would receive the assets of the husband's trust outright and pursuant to the reformation of that trust, she had a right to disclaim any or all of the assets and have them held in a credit shelter trust. The husband also proposed to amend his will, providing for the exercise of the general power of appointment granted to him and appoint the assets with a value equal to the amount of remaining applicable exclusion amount to the trustee of the wife's trust. The Internal Revenue Service ruled that if the husband predeceased the wife, the value of the wife's trust over which the husband had a general power of appointment would be includable in his gross estate under I.R.C. §2041. If the husband exercises his testamentary general power of appointment, the wife would be treated as relinquishing her dominion and control over the property subject to the power. Furthermore, the Internal Revenue Service determined that the portion of the assets appointed by the husband would be treated as a completed gift by the wife which would qualify for the gift tax marital deduction. Because the assets originally held in the wife's trust would be distributed according to the terms of the husband's will, the Internal

Revenue Service concluded that those assets would not constitute gifts from the wife to the other beneficiaries of the second trust and would not be includable in the wife's gross estate.

G. Proceeds of Life Insurance (I.R.C. §2042)

1. *Estate of Blount v. Commissioner, 428, F.3d 1338 (11th Cir. 2005)*

The 11th Circuit reversed the Tax Court finding it erred in ignoring an agreement creating a contractual liability for a corporation which insurance proceeds were committed to satisfy. Blount Construction Company had entered into an agreement with its shareholders that required shareholder consent to a transfer of stock and established that the company would purchase the stock on the death of the holder at a price agreed upon by the parties or a purchase price based on the book value of the corporation. The company bought insurance policies to fulfill its commitment to purchase stock under the agreement. The Court had held that the agreement should be disregarded for purposes of determining the value of the shares and that the insurance proceeds should be added to the other assets of the corporation in order to arrive at fair market value. The Court of Appeals found that the Tax Court properly determined that the agreement had no effect for the purposes of determining the value of the company shares but that it erred when it ignored the agreement's creation of a contractual liability for the company which the insurance proceeds were committed to satisfy. Thus, the Court rejected the Tax Court's inclusion of the insurance proceeds in the computation of the company's fair market value.

2. *Priv. Ltr. Rul. 200617008 (April 28, 2006)*

The proceeds of a policy of life insurance held by a trust would not be includable under I.R.C. §2042(2) in the estate of a beneficiary who resigns as co-trustee or under I.R.C. §2035(a) if she dies within three years of resigning as co-trustee. A husband established an irrevocable trust for the benefit of his wife. After the husband died, the wife was to serve as

co-trustee of the trust. However, she will resign and the wife's father will serve as sole trustee and in that capacity will purchase a life insurance policy on the wife's life. The trust will be the owner and beneficiary of the policy. The Internal Revenue Service has ruled that the proceeds of the policy will not includable in the wife's gross estate either as an owner under I.R.C. §2042(2) or under the three-year rule of I.R.C. §2035(a).

H. Certain Property for Which Marital Deduction Was Previously Allowed (I.R.C. §2044)

Tech. Adv. Mem. 200602033 (January 13, 2006)

The value of a promissory note and withdrawn assets attributable to two qualified terminable interest property (QTIP) trust were includable in the decedent's gross estate under I.R.C. §2044. Although not authorized by his predeceased spouse's trust agreement, the decedent withdrew all of the assets from the QTIP trust, for which an estate tax marital deduction had been taken. In addition, a promissory note that appeared to be an asset of the QTIP trust was endorsed to the decedent, individually. On audit, the value of these assets held in the individual's name were included in his gross estate. The estate sought a refund claiming that none of the assets were includable because by withdrawing the assets from the QTIP trust, the decedent disposed of his qualified income interest and therefore, the unauthorized withdrawals resulted in the imposition of a constructive trust. The Internal Revenue Service ruled that the decedent did not dispose of his qualified income interest in the QTIP trust after the withdrawals because he was in possession of and retained an income interest in the assets the estate claimed to be transferred. Accordingly, the transaction was not a disposition that resulted in a gift and the assets attributable to the QTIP trust and the promissory note were includable in his gross estate under I.R.C. §2044. The Internal Revenue Service rejected the estate's constructive trust

argument because (1) the parties adversely effected did not seek relief in a court of equity; and (2) a constructive trust was not imposed on the property by any court.

I. Expenses, Indebtedness and Taxes (I.R.C. §2053)

1. *Estate of Tehan v. Commissioner, T.C. Memo 2005-128*

On the decedent's estate tax return, the personal representative claimed and a Maryland Probate Court allowed $32,000 for personal representative's commissions. The Internal Revenue Service issued a deficiency disallowing nearly $21,000 of the personal representative's fees. Under Maryland law, the Court observed that the maximum amount of compensation due the personal representative is based on the amount of property subject to administration and although the excess amount had been approved by the Probate Court, the estate was not allowed to deduct amounts in excess of the statutory maximum.

2. *Tech. Adv. Mem. 200532049 (August 12, 2005)*

The personal representative, in filing a claim for refund, asserted that a deduction should be allowed for attorney's fees and litigation expenses arising from a malpractice action. In examining whether a deduction should be allowed, the Internal Revenue Service noted that to be deductible under I.R.C. §2053, the expense must be allowable under applicable state law and must be actually and necessarily incurred in the administration of the estate. The Court held that this criteria was met under applicable state (Maryland) law and thus, was deductible as administration expenses.

3. *Estate of Strangi v. Commissioner, 429 F.3d 1154 (5th Cir. 2005)*

In what may be the final Strangi decision, the 5th Circuit has granted the petitioner's unopposed petition for rehearing for the limited purpose of determining allowable administration expenses including attorneys' fees.

4. *Estate of Hughes v. Commissioner, T.C. Memo. 2005-296*

A promissory note was not deductible as a claim against a decedent's gross estate under I.R.C. §2053(a)(3) because the underlying stock subscription agreement was not contracted bona fide and the decedent did not receive full and adequate consideration in the transaction. Apparently, at the time the decedent's husband died, the value of stock of a used car dealership was placed at zero because the company's liabilities exceeded its assets. Subsequently, the decedent executed a promissory note under which the decedent agreed to pay the company on demand $400,000 in exchange for an additional 4,000 shares of stock. After the decedent's death, $400,000 was transferred to the company which in turn, repaid a limited partnership in which the decedent's children and grandchildren held a 99.419% interest. On the decedent's estate tax return, the estate deducted the $400,000 promissory note. The Court held that the estate could not deduct the $400,000 because the stock subscription was not bona fide or for full and adequate consideration. The Court concluded that the 4,000 shares were worthless because the company had no value at the time the promissory note was executed. Further, the Court found that the decedent's children and grandchildren received the $400,000 as a substitute for a testamentary disposition.

J. Transfers for Public, Charitable and Religious Uses (I.R.C. §2055)

1. *Priv. Ltr. Rul. 200535006 (September 2, 2005)*

A decedent's estate was allowed a charitable deduction for the value of the remainder interest in a trust because a reformation of the trust resulted in a qualified reformation under I.R.C. §2055(e)(3). The decedent's will provided that the residue of the estate was to be held in trust for the benefit of his son and upon his son's death, four charities and the son's brother. During his life, the son was to receive at least 50% of the trust income with the corporate trustee permitted to make discretionary distributions of income for the son's comfort, maintenance or support. In addition, the trustee could make discretionary distributions from the

trust principal for the son's medical expenses. Following the decedent's death, the son disclaimed the discretionary invasion of principal for his medical expenses. The estate later commenced a judicial proceeding to reform the decedent's will and as a result of the reformation, one-half (1/2) of the residue of the estate was allocated to a charitable remainder unitrust. The Internal Revenue Service observed that as long as the son's disclaimer of his interest in the principal was a qualified disclaimer, the son's right to receive the unitrust income would be considered to be the only non-charitable for estate tax purposes and thus, the charitable interest prior to the reformation was a reformable interest. In addition, the reformation satisfied the requirements of I.R.C. §2055(e)(3) and thus, the trust met the requirements of a charitable remainder unitrust under I.R.C. §664.

2. *Estate of Jackson v. United States, 408 F.Supp.2d 209 (N.D. W.Va. 2005)*

The estate was entitled to a charitable deduction for a gift to a charitable beneficiary because the split interest exception of I.R.C. §2055(e)(2) did not apply to the distributed property. The decedent's trust instrument provided for immediate cash distributions upon her death to her nephew and three nieces. The nephew and three nieces also received one-fourth (1/4) income interest in the balance of the trust estate with a church named as a remainder beneficiary. Subsequent to the decedent's death, the family beneficiaries and the church signed an agreement to terminate the trust because the trustees were concerned about the possibility of disputes arising from potential conflicts of interest. Under the termination agreement, the trust beneficiaries received the actuarial value of the income interest and the church received the remainder. The Court noted that although the trust did not conform to the requirements of I.R.C. §2055(e)(2) and that a qualified reformation was not made, an intervening event terminated the

charitable split interest and caused a direct distribution of property to the charitable organization. Consequently, the estate was entitled to a charitable deduction.

3. *Priv. Ltr. Rul. 200541038 (October 14, 2005)*

A decedent's estate was allowed a charitable deduction for the value of a remainder interest in a statutory elective share trust because a proposed reformation of the trust resulted in a qualified reformation under I.R.C. §2055(e)(3). The decedent's will made bequests to the decedent's two children and several other bequests including the residue of the estate to a charitable organization. In accordance with applicable state law, the surviving spouse elected under the decedent's will and subsequently disclaimed a portion of the assets that would otherwise pass to the surviving spouse because of the election. As a result of the election and disclaimer, the residue of the decedent's estate was held in a statutory elective share trust. Under the terms of the trust, the surviving spouse would receive income for life and pursuant to the decedent's will, the remainder of the trust would pass to the charitable beneficiaries. Because the statutory trust did not qualify as a charitable remainder trust, the parties proposed to reform the trust to qualify as a charitable remainder unitrust. The Court found that the charitable remainder interest was a reformable interest as described in I.R.C. §2055(e)(3)(C) and that the proposed reformation of the trust was a qualified reformation within the meaning of I.R.C. §2055(e)(3).

4. *Priv. Ltr. Rul.* 200548019 (December 2, 2005)

The decedent's estate was not granted an extension of time to commence a judicial reformation of a split interest trust because such relief was not available under Treas. Reg. §301.9100-3. The Internal Revenue Service noted that discretionary relief was available under Treas. Reg. §301.9100-3 for regulatory elections but not statutory elections. The deadline for commencing the judicial proceeding was prescribed by statute making it a statutory election

for purposes of Treas. Reg. §301.9100-1(a). Therefore, no relief could be granted to the estate with respect to an extension of time to commence the judicial reformation.

5. *Galloway v. United States, 2006 WL 1233683 (W.D. Pa. 2006)*

A trust created by a decedent in which his son and granddaughter and two charitable entities were given equal residual shares distributed to them on two dates is a "split interest trust" for which decedent's estate is not entitled to a charitable deduction. The decedent's trust provided that the residue would pass in four equal shares to two natural persons as well as two charitable entities. The trust documents provides for staged distributions and further provides with respect to the individual beneficiary that if either of them is not living at the time of final distribution, his or her share will be distributed to the remaining beneficiaries. If both individual beneficiaries are deceased, the entire corpus would go to the charitable beneficiaries. The estate tax return claimed a charitable deduction equal to the portion of the corpus that was determined to be ultimately distributed to the charitable beneficiaries. The Internal Revenue Service determined the trust constituted a "split interest" trust that divided the same property between charitable and non-charitable beneficiaries. The Internal Revenue Service then denied the claimed deduction in ruling for the Internal Revenue Service holding that where a trust creates a "split interest" no charitable deduction is allowed unless the trust is a charitable remainder trust.

K. Marital Deduction (I.R.C. §2056)

1. *Estate of Lurie v. Commissioner, 425 F.3d 1021 (7th Cir. 2005)*

The decedent's mother had created 10 trusts for his benefit. At the time the decedent established his own estate plan, he assumed that the trusts established by his mother would not be included in his estate for estate tax purposes. He directed that a revocable trust he had established would pay any estate tax if his probate estate was insufficient. After audit, it was

concluded that the mother's trusts were in fact taxable in the decedent's estate resulting in approximately $12,200,000.00 of additional estate tax. The Court held that this tax should be paid from the decedent's revocable trust with the effect that the marital deduction would be reduced accordingly. Since the marital deduction had been utilized to reduce the decedent's estate tax to zero, the payment of additional tax will have the effect of creating tax on the estate tax deficiency by virtue of the reduction of the marital deduction.

2. *Priv. Ltr. Rul. 200535026 (September 2, 2005)*

A qualified terminable interest property (QTIP) election made with respect to a credit shelter trust was disregarded for federal transfer tax purposes because the election was unnecessary to reduce the decedent's estate tax liability to zero. Because the QTIP election was unnecessary to reduce the estate tax liability to zero, the Internal Revenue Service noted that Rev. Proc. 2001-38, 2001-1C.B. 1335 applied. Accordingly, the Internal Revenue Service ruled that the property held in the credit shelter trust would not be includable in the surviving spouse's gross estate under I.R.C. §2044.

3. *Priv. Ltr. Rul. 200536015 (September 9, 2005)*

On the decedent's federal estate return, the estate elected qualified terminable interest property (QTIP) treatment for two marital trusts. After the estate tax return was filed, the estate's personal representative discovered a promissory note that had inadvertently not been reported on the Form 706. If the existence of the note had been known when the estate tax return was filed, the note would have funded one of the marital trusts and would have been subject to the QTIP election. The Internal Revenue Service ruled that the filing of a supplemental Form 706 for the decedent's estate in order to report the value of the note will cause the QTIP election to be deemed made with respect to that asset.

4. *Sowder v. United States, 407 F.Supp.2d 1230 (E.D. Wash. 2005)*

The decedent's gift to the surviving spouse qualified for the unlimited marital deduction under I.R.C. §2056 because the totality of the circumstances surrounding the drafting of his will evidenced his intent that the gift would qualified for the deduction. In 1983, the decedent prepared his own will giving each of his children $200,000 which was equivalent to the amount that could pass tax free to a non-spouse beneficiary after 1987. The remainder of the decedent's estate was left to his wife if she survived him. The will provided that if the decedent's wife did not survive him or died before the estate was distributed to her, the remainder was given to the decedent's surviving issue. The Internal Revenue Service denied the marital deduction stating that the bequest did not qualify because the language of the will required distribution if the wife died prior to distribution of the estate. In accordance with Washington state law, the Court concluded that the estate proved that the decedent intended the gift to qualify for the unlimited marital deduction evidenced by the following: (1) the decedent's awareness of the 1981 change in the tax law that created the unlimited marital deduction; (2) the decedent did not change his will after the purchase of the "last to die" insurance insuring the decedent and his wife payable upon the death of the survivor; and (3) the decedent's specific bequests to his children were equal to the amount that would pass tax free to a non-spouse.

5. *Estate of Buder v. United States*, *436 F.3d 936 (8th Cir. 2006*)

At the time of the decedent's husband's death in 1984, a marital deduction was claimed for a qualified terminable interest property (QTIP) trust notwithstanding that the trust did not qualify. Subsequently when the decedent died, the property was included in the decedent's estate. The estate then filed a claim for refund based on the fact that the property should not have been includable in the estate by virtue of the prior QTIP election. The Court ruled that the estate was entitled to the refund but that the government was entitled to equitable

recoupment of the estate taxes that should have been paid on the non-qualified QTIP trust since the marital deduction would not have been available in the predeceased husband's estate.

6. *Priv. Ltr. Rul. 200540003 (October 7, 2005)*

A decedent's estate was denied an extension of time to make an I.R.C. §2056(b)(7) qualified terminable interest property (QTIP) election with respect to the balance of a trust because a partial QTIP election was made on the decedent's federal estate tax return. The Internal Revenue Service noted that relief under Treas. Reg. §301.9100-3 is granted only when a taxpayer has failed to make a timely election and once the election was made, relief would not be granted to alter or modify the election.

7. *Priv. Ltr. Rul. 200543037 (October 28, 2005)*

Two separate court orders, one regarding the payment of estate taxes upon the death of the surviving spouse and the other construing the surviving spouse's will were given effect by the Internal Revenue Service for estate and generation-skipping transfer tax purposes. The decedent's will created a marital trust for the benefit of his surviving spouse. Subsequently, a state court granted the petition to divide the marital trust into an exempt and non-exempt trust for generation-skipping transfer tax purposes and directed that all estate and inheritance taxes attributable to the trust upon the surviving spouse's death be allocated against the non-exempt trust. The Internal Revenue Service noted that although a federal court or agency is not bound by a state court action, the parties to the state court action are bound by the decision. The Internal Revenue Service then concluded that the state court's order which directed that all estate and inheritance taxes attributable to the inclusion of the exempt and non-exempt trust in the surviving spouse's gross estate should be payable out of the non-exempt trust would be given effect.

8. *Priv. Ltr. Rul. 200603004 (January 20, 2006)*

A qualified terminable interest property election with respect to a credit shelter trust was ruled null and void. The Internal Revenue Service ruled that the QTIP election for the value of property passing to the credit shelter trust is null and void because no estate tax was due and the QTIP election extended to assets of the credit shelter trust over which a QTIP was not necessary to reduce the estate tax liability to zero.

9. *Priv. Ltr. Rul. 200608019 (February 24, 2006)*

A decedent's estate was granted a 60-day extension of time to make a qualified terminable interest property (QTIP) election with respect to a fractional or percentage share of a credit-shelter trust. Subsequent to the filing of the federal estate tax return, the estate attorney discovered that because the decedent made adjusted taxable gifts, the estate tax liability could not be zero unless a QTIP election was made for a fractional share of the credit-shelter trust. The Internal Revenue Service allowed the extension of time to make the election because the requirements of Treas. Reg. §§301.9100-1 and 301.9100-3 were satisfied because the estate acted reasonably and in good faith by relying on the advice of a qualified tax professional and granting the relief would not prejudice the interest of the government.

10. *Priv. Ltr. Rul. 200618018 (May 5, 2006)*

When the executor of a decedent's estate filed the federal estate tax return, no qualified terminable interest property (QTIP) election was taken as the executor claimed a charitable deduction which eliminated the tax. When the estate tax return was audited, the Internal Revenue Service disallowed the charitable deduction. The Internal Revenue Service in this ruling has granted an extension of time allowed to file the QTIP election acting pursuant to Treas. Reg. §§301.9100-1 and 301.9100-3.

11. *Priv. Ltr. Rul. 200612001 (March 24, 2006)*

A qualified terminable interest property (QTIP) election did not apply to assets that were the subject of invalid disclaimers because the assets were not specifically identified on Schedule M of the decedent's federal estate tax return. Based on an attorney's advice, disclaimers were prepared for a surviving spouse in order to allow certain assets to pass directly from the decedent's estate to the decedent's children and grandchildren. However, it was subsequently determined that the disclaimers prepared by the family's attorneys were invalid, both by their terms and under state law; thus, the assets subject to the invalid disclaimers passed to a marital trust. Since the QTIP election was made only with respect to assets specifically identified on Schedule M and not the disclaimed property, a timely QTIP election was not made.

L. Extension of Time for Payment of Estate Tax (I.R.C. §6166)

1. *Priv. Ltr. Rul. 200521014 (May 27, 2005)*

A decedent's interest in real estate assets qualify as an interest in a closely-held business. When decedent's spouse suffered intermittent health problems, decedent assumed the duties that her spouse customarily performed for various real estate assets. When the decedent encountered physical limitations herself, the spouse managed the individually-owned real estate as her agent under a durable power of attorney. If both experience health problems, their son assumes those duties. When the spouse died, he was managing real estate properties through a proprietorship which had 20 full-time employees with decedent, the spouse or the son supervising various agents and employees including on-site managers to approve lease applications, perform routine maintenance and repair kept financial records. The Internal Revenue Service found that Rev. Ruls. 75-365, 75-366 and 75-367 suggest that the level of activity is the factor that distinguishes a trade or business under I.R.C. §6166 from the mere management of rental properties.

2. *Priv. Ltr. Rul. 200529006 (July 22, 2005)*

The Internal Revenue Service explains in this ruling that I.R.C. §6601(j) charges interest at different rates during the period of an extension of time for payment of estate tax under I.R.C. §6166. Interest on the "2% portion" of the tax is charged at a 2% rate and the remainder of the tax is charged at 45% of the annual rate under §6601(a). Absent an express limitation, the interest rate on the remaining portion of the tax over and above the 2% portion will be at the federal short-term rate as it changes each quarter.

Additionally, the Internal Revenue Service found that the 20% test of I.R.C. §6166 (b)(1)(D) is met because the decedent's brother's shares are attributed to her.

3. *Priv. Ltr. Rul. 200613020 (March 31, 2006)*

A distribution to a decedent's daughter of part or all of a certain percentage interest in a partnership held by a trust did not cause the cessation of the extension of time for payment of estate tax under I.R.C. §6166(a). The decedent's trust provided that when her daughter reached certain ages, she was entitled to withdraw up to one-half of the trust assets or the balance. The trust owned a specific percentage interest in a partnership and on the decedent's estate tax return, the executor elected to defer payment of estate tax attributable to the percentage interest. The Internal Revenue Service found that transfers of property to a person entitled to receive the property either under a decedent's will or trust would not cause the acceleration of the deferred payment of estate tax.

M. Special Lien for Estate and Gift Taxes (I.R.C. §6324)

1. *First American Title Insurance Company, et al. v. United States, 2005-1 U.S.T.C. ¶60,501 (W.D. Wash. 2005)*

The special estate tax lien that attached to three homes included in the gross estate of a decedent pursuant to I.R.C. §6324(a)(1) was not divested because three title

companies could not prove that the proceeds from the home sales were used to satisfy the estate's tax obligations. Subsequent to the decedent's death, the decedent's daughter, who was also the estate's personal representative, deeded the three homes in the estate to herself and then sold the homes to three purchasers who obtained title insurance from the three title companies. Apparently, after the sales, the Internal Revenue Service increased the value of the decedent's gross estate and determined a deficiency in the amount of tax owed. The Court noted that a gross estate is divested of the special estate tax lien only to the extent that the gross estate was "used for the payment of charges against the estate and expenses of its administration". Since the title companies could not show that the sales proceeds were used to satisfy charges against the estate, the Court found that the special estate tax lien was not discharged.

2. *FAA 20061702F (May 3, 2006)*

A federal estate tax lien on a parcel of real estate is divested to the extent of a security interest in the property held by a lender to the deceased owner's son. If property encumbered by a special lien is transferred by a beneficiary to a purchaser or holder of a security interest, I.R.C. §6324(a)(2) says that the property is to that extent divested of the statutory estate tax lien and a "like lien shall then attach to all the property" of such beneficiary. The Internal Revenue Service's Chief Counsel's office concluded that the pledge of the real estate by the decedent's son, as collateral, constitutes a transfer within the meaning of I.R.C. §6324(a)(2).

N. Release of Tax Lien (I.R.C. §6325)

Estate of Kanter v. Commissioner, T.C. Memo. 2006-46

An estate's motion to abate tax assessments and to release tax liens was denied by the Tax Court. The Tax Court rejected the estate's argument that the liens should be released because the assessments that they secured were invalid. Apparently, the estate had not posted an appeal bond when it appealed an original decision and therefore, collection

proceedings were not stayed during the estate's various appeals. Moreover, none of the Appellate Court's decisions determined the correct amount of the estate's deficiencies or procluded the Tax Court from making another deficiency determination.

O. Closing Agreements (I.R.C. §7121)

United States v. Irby, 2005 WL 3536345 (S.D. Ala. 2005)

The executors of an estate were personally liable for the estate's federal tax liability including interest and penalties because of their failure to pay the federal taxes in full prior to distributions to the estate's creditors.

P. Awarding of Costs and Certain Fees (I.R.C. §7430)

1. *Estate of Baird v. Commissioner, 416 F. 3d 442 (5TH Cir. 2005)*

The estates of decedent spouses were entitled to litigation and administration costs under I.R.C. §7430 because the Internal Revenue Service position in the underlying estate tax proceeding was not substantially justified. In valuing the estates' respective partial interests in a Louisiana trust that held timber land, the Internal Revenue Service took the position that partition of the realty was the only viable option and that the cost of partition would be less than the fractionalization discounts claimed by the estates. Six months prior to the notices of deficiency, and before the Internal Revenue Service established its position, the estates provided evidence to the Internal Revenue Service supporting the fractionalization discounts and countering the Internal Revenue Service's expert's opinion with regard to partition. Despite the evidence provided by the estates, the Court noted, the Internal Revenue Service maintained the position that the only allowable discount was the estimated costs of partition. Therefore, the Court concluded that the Tax Court abused its discretion in holding the Internal Revenue Service's position was substantially justified. Apparently, the

Internal Revenue Service never budged from its position that partition was the only discount allowable.

2. *Cameron v. United States, 2005-1 U.S.T.C. ¶60,503 (W.D. Pa. 2005)*

An estate was entitled to an award of attorney's fees and costs incurred in estate tax litigation because the government's position was not substantially justified. The decedent's estate filed a federal estate tax return that did not include the value of a trust created by the decedent's sister and the Internal Revenue Service assessed a deficiency of almost $598,000 asserting that 50% of the remainder of the sister's estate was includable in the decedent's estate. The District Court held that the estate was entitled to attorney's fees and costs because the government's position was not substantially justified and the estate was the prevailing party. The Court found that the government did not justify its position because (1) the government cited no authority to support its position that a literal reading of the sister's testamentary documents yielded the result that she intended to give the decedent an interest; (2) the government's result was not supported by the literal reading of the document because applicable state law provided that a decedent and a decedent's estate were two separate entities; and (3) the Court has previously determined that the government's conclusion was an "absurd result".

3. *Rathbun v. Commissioner, 125 T.C. No. 2 (2005)*

Taxpayer and their four children were not entitled to costs under I.R.C. §7430 for expenses incurred in administrative proceedings with the Internal Revenue Service involving their 1993 gift tax liabilities. Apparently, the father had purchased a winning lottery ticket on behalf of an informal family limited partnership which was capitalized two days later to collect, manage and distribute the lottery winnings. The Internal Revenue Service asserted that

the parents owned the lottery ticket and that capitalizing the family limited partnership with the right to collect the winnings was a taxable gift to the children. After a settlement agreement was reached, the taxpayers submitted a request for costs. The Court observed that in order for the taxpayers to be the prevailing parties entitled to administrative costs, the government's position must be not substantially justified. The Court found that the government did not take such a position for purposes of I.R.C. §7430 and the taxpayers were not the prevailing parties.

Q. Timely-Made Mailing Treated as Timely-Filing (I.R.C. §7502)

Estate of Kalman v. Commissioner, 2006 WL 407073 (D.S.C. 2006)

The federal District Court did not have subject matter jurisdiction over an estate's suit for a refund of estate tax because the estate failed to timely file a claim for refund. The estate mailed the decedent's federal estate tax return on June 5, 2000. Subsequent to the filing of the return, the estate sought a refund of amounts paid. On June 4, 2003, the special administrator of the estate prepared an amended return. The envelope containing the amended return was postmarked using a private postage meter but the envelope did not have a postmark date because the date function on the postage meter was switched off. On June 5, 2003 the envelope carrying the amended return was placed in a mail box in front of the special administrator's office and the amended return was received on June 9, 2003. The Internal Revenue Service disallowed the estate's claim for refund since where a claim is received after the due date, the post mark date is deemed the date of delivery but because the envelope containing the return did not have a postmark date on it, the estate's claim for refund did not comply with I.R.C. §7502. The Court stated that proof of timely mailing by itself was not sufficient to demonstrate compliance. Consequently, the court held that the claim for refund was filed on June 9, 2003 when it was received by the Internal Revenue Service.

R. Valuation Tables (I.R.C. §7520)

1. *Anthony v. Commissioner, 2005-2 U.S.T.C. ¶60,504 (M.D. La. 2005)*

The right of a decedent's estate to receive payments from a structured settlement was valued for estate tax purposes by using I.R.C. §7520. As a result of a personal injury sustained in 1990, the decedent was the beneficiary of two annuity contracts which provide for scheduled monthly payments for 15 years and then for his life while another contract guaranteed 15 annual lump sum payments. After his death in 1996, the decedent's estate valued the total interest using the I.R.C. §7520 annuity tables. The estate argued that restrictions on the transfer of the settlement payments had to be considered for valuation purposes. On audit, the Internal Revenue Service increased the estate tax after increasing the value of one of the annuity contracts. The Court first concluded that a structured settlement agreement constituted an annuity for the purpose of valuation. The Court then concluded that the annuity tables should be utilized and that factoring non-marketability into the valuation of a structured settlement was inappropriate because non-marketability was an assumption underlying the annuity tables.

2. *Davis v. United States, 2006 WL 213761 (D. NH. 2005)*

The estate tax valuation of future lottery payments was not determined on summary judgment because it could not be concluded as a matter of law that the use of the I.R.C. §7520 annuity tables was either appropriate or inappropriate. In 1989, the decedent won the Massachusetts lottery entitling him to annual payments of $209,220.00 for 20 years. The decedent died after receiving 10 of those payments and at his death, the remaining 10 payments became payable to his estate. On the decedent's estate tax return, the estate reported the value of the 10 future payments based on the annuity tables contained in I.R.C. §7520. The estate subsequently filed an informal claim for refund contending that the correct value of the

remaining payments was actually less since the annuity tables failed to take into consideration the fact that it's right to receive the payments was a non-marketable asset and could not be sold, assigned or otherwise transferred. The estate and the government filed cross motions for summary judgment. The Court noted that there was a split among the various courts over the use of the annuity tables in valuing lottery payments and relying on Shackleford v. United States, 262 F.3d 1028 (9th Cir. 2001) and Gribauskas v. Commissioner, 342 F.3d 85 (2d Cir. 2003) cases concluded that (1) the annuity tables did not take into account an asset's non marketability; (2) the fair market value of a non-marketable annuity was less; and (3) the annuity tables were therefore, not necessarily an accurate measure. However, in order to prevail on summary judgment, the estate was still required to show that an alternative method of valuing the lottery payments was required to be used

IV. FEDERAL CASES AND RULINGS – GIFT TAX

A. Taxable Gifts (I.R.C. §2503)

Priv. Ltr. Rul. 200608011 (February 24, 2006)

A donor's transfer to a non-profit club was treated as a gift to a single entity and would be excludable for gift tax purposes under I.R.C. §2503(b). As a general rule, a gift to a corporate entity is a gift to the individual shareholders. However, a gift to a tax-exempt entity is within the exception to the general rule of Treas. Reg. §25.2511-1(h)(1) for charitable, public, political or similar organizations and therefore, the donor's gift to the club would be deemed a gift to the club as a single entity. The gift would, however, be excludable under I.R.C. §2503(b) to the extent that the gift did not exceed the annual exclusion.

B. Gift Tax Exclusion for Gifts to Pay Educational or Medical Expenses (I.R.C. §2503(e))

Priv. Ltr. Rul. 200602002 (January 13, 2006)

A grandparent's prepaid tuition payments for each of six grandchildren for each grade level through grade 12 were qualified transfers for purposes of the I.R.C. §2503(e) unlimited gift tax exclusion. The grandparent proposed to enter into six individual agreements with a qualified educational organization. Pursuant to the agreements, the grandparent prepaid the total annual tuition for each grandchild for each grade through grade 12. The payments were non-refundable and once paid, became the sole property of the school. Pursuant to the agreements, a respective grandchild would not be afforded any additional rights or privileges over any other students and would not be guaranteed enrollment. The Internal Revenue Service concluded that the advanced tuition payments met the I.R.C. §2503(e) exclusion because: (1) the payments were made directly to the school; (2) the agreements between the grandparent and the school provided that the prepayments were to be used for the payment of specific tuition cost for each grandchild; and (3) the payments were non-refundable and would be forfeited if a respective grandchild did not attend the school.

C. Transfers Subject to Gift Tax (I.R.C. §2511)

1. *Priv. Ltr. Rul. 200533001 (August 19, 2005)*

The taxpayer owns a membership in an I.R.C. §501(c)(7) social club that is organized as a non-stock membership corporation. The taxpayer intends to make a cash contribution to the club and taxpayer sought a ruling that an annual contribution of cash to the club will be treated as a gift to a single entity that will qualify for the I.R.C. §2503(b) annual gift tax exclusion. The Internal Revenue Service found that an unrestricted gift to the club will not be limited to commencement, use, possession or enjoyment at some future time and so will not

constitute a gift of a future interest. Thus, it will be a gift of a present interest and excludible from taxable gifts to the extent it does not exceed the I.R.C. §2503(b) limit. Further, the gift will not be treated as a gift of a future interest to the various members of the organization.

2. *Priv. Ltr. Rul. 200534014 (August 26, 2005)*

A transfer of stock from a father to his son, effected by changing the father's name to the son's name on the stock register of a corporation and the ownership registries of a limited partnership and a limited liability company was not a gift under I.R.C. §2511. Because the son was experiencing credit difficulties, the father purchased shares in the corporation with funds provided by the son and held title to the corporation's shares for the benefit of and on behalf of his son. As a shareholder, the father received distributions of interests in a limited partnership and a limited liability company. When the father's credit rating was no longer needed by the corporation, the father transferred the shares and the interests in the partnership and limited liability company to his son. The Internal Revenue Service concluded that the father never acquired an interest in the corporation and that the corporation's shares were held in a resulting trust for the benefit of the son.

3. *Priv. Ltr. Rul. 200535012 (September 2, 2005)*

Taxpayer has attained the age of majority under state law and plans to disclaim her contingent right to trust corpus on the termination of four (4) trusts. The four trusts were created by the taxpayer's great-grandparent and were created prior to 1977. Relying on Jewett v. Commissioner, 455 U.S. 305 (1982), the Internal Revenue Service found that the disclaimer will be timely under the Treas. Reg. §25.2511-1(c)(2). Consequently, the taxpayer's disclaimers did not constitute transfers subject to gift tax under I.R.C. §2511.

4. *Priv. Ltr. Rul. 200534015 (August 26, 2005)*

Assignment of potential proceeds of a wrongful death action or a settlement of that action to a trust constitutes a completed gift at the time of the assignment. After the taxpayer's husband was killed, the taxpayer filed a wrongful death action and then created an irrevocable trust for the benefit of her children and more remote descendants. The trust instrument prohibits the taxpayer from serving as a trustee and requires that at least one trustee be an independent trustee who has no present or future beneficial interest in the trust. Although the trust is irrevocable, it may be amended by action of all of its independent trustees but only to the extent that the amendment clarifies the meaning of any provision, alters or adds to the administrative powers or alters or adds to the trust for the purpose of bringing its provisions into conformity with federal and state tax laws. The Internal Revenue Service concluded that taxpayer's proposed assignment of a portion of the potential proceeds from the wrongful death action will constitute a completed gift at the time of the assingment.

5. *Senda v. Commissioner, 433 F.3d 1044 (8th Cir. 2006)*

A couple's transfers of stock to two family limited partnerships (FLPs) were indirect gifts of the stock to the couple's children. The couple created two family limited partnerships and transferred shares of stock for their partnership interest. The couple contended that they made gifts of partnership interest to their children with the value computed by applying applicable discounts. The Internal Revenue Service argued that the couple made indirect gifts of stock to their children valued at the full undiscounted value. The Tax Court ruled in favor of the Internal Revenue Service and found indirect gifts. The Appellate Court affirmed the Tax Court's decision holding that the couple's transfers of stock to the family limited partnerships were indirect gifts of stock to their children because the couple did not present reliable evidence that they contributed the stock to the partnership before they transferred the partnership interests to

the children. Although the couple presented their gift tax returns, the FLPs' income tax returns and certificates of ownership, the Tax Court did not err when it ruled that these documents were unreliable.

6. P*riv. Ltr. Rul. 200612002 (March 24, 2006)*

A donor's contribution to a trust would not be a completed gift subject to gift tax because of the powers retained by the donor. The trust provided that net income and principal would be distributed when the donor and one member of a power of appointment committee agreed to appoint the property to one or more members of a class which included the donor, the donor's descendants, the committee members, a named beneficiary and a named private foundation. Additionally, the donor possessed a limited testamentary power of appointment. Because of the donor's retained powers to appoint trust property, the Internal Revenue Service concluded that the donor's contribution of property to the trust would be an incomplete gift in accordance with Treas. Reg. §25.2511-2. The Internal Revenue Service further noted that if the trust corpus was distributed to someone other than the donor or the donor released the power of appointment, the donor would be deemed to make a taxable gift.

7. *Priv. Ltr. Rul. 200617002 (April 28, 2006)*

The remainder beneficiaries did not make taxable gifts when the grantors made unauthorized transfers of a residence from their qualified personal residence trusts to their revocable living trust. The decedent and his spouse had created qualified personal residence trusts (QPRT) and conveyed a one-half interest in their principal residence to each of their trusts. After the creation of the QPRT, the decedent's spouse developed severe health problems and became distressed about the loss of the residence on termination of the QPRT. Consequently, the decedent and the spouse executed deeds conveying their interest in the residence to a revocable trust. The remainder beneficiaries who were four daughters who apparently were not

consulted or aware of the action of the decedent and the spouse. Subsequently, it was agreed that the daughters would receive the sales proceeds in settlement of their claims. The Internal Revenue Service concluded that the daughters did not relinquish or otherwise transfer the remainder interest on the transfer of the residence to the revocable trust established by the decedent and spouse. Accordingly, the Internal Revenue Service concluded that the daughters did not make taxable gifts.

D. Valuation of Gifts (I.R.C. §2512)

1. *Smith v. United States, 2006 WL 1984646 (W.D. Pa. 2005)*

The decedent, Sydney E. Smith, Jr., created a limited partnership on December 29, 1997 and subsequently gifted minority interests to his two children, the plaintiffs in this case. The plaintiffs contend that the value of the limited partnership interests are subject to significant marketability discounts due to a provision in the partnership agreement that limits the price and the terms upon which the partnership would be required to pay a partner for his interest if the partnership exercise a right of first refusal. The Internal Revenue Service, however, disregarded this provision, applying I.R.C. §2703(a), in granting the government's motion for partial summary judgment and denying the plaintiffs' motion for partial summary judgment. The Court found that the restrictive agreement must be binding on the parties during life and after death. The unilateral authority of the decedent to alter the terms of the agreement during his lifetime rendered the agreement non-binding. In reading the provisions of the partnership agreement, the Court found that the decedent retained the unilateral ability to amend or modify the agreement.

2. *United States v. Davenport, 2006 WL 148896 (S.D. Tex. 2006*)

The government's claim for unpaid gift tax fails as a matter of law and decedent defendant's motion for summary judgment is granted since the government bears the

burden of proof and all evidence it proposes to introduce at trial to prove the per share value of 1,610 shares of Honda stock is for one or more reasons inadmissible.

3. *Priv. Ltr. Rul. 200551013 (December 23, 2005)*

An estate of a terminally ill donor was provided a special actuarial factor to be used in valuing gifts of a life estate interest in 20 parcels of real property made by the donor. Pursuant to the regulations, the donor's estate requested a ruling for the applicable actuarial value to be used in valuing the gifts of the life interest. The Internal Revenue Service noted that the fair market value of the life estate was the present value of the interest calculated in accordance with Treas. Reg. §25.2512-5(d)(2) and by the use of special or standard I.R.C. §7520 actuarial factors. The Internal Revenue Service concluded that because the donor was terminally ill as described in Treas. Reg. §25.7520-3(b)(3) when the gifts were made, the I.R.C. §7520 mortality component for ordinary life estates would not be used.

4. *Priv. Ltr. Rul. 200603002 (January 20, 2006)*

A proposed reformation and assignment of a second to die life insurance policy from a husband and wife to a trust which was revocable by their children would not result in a taxable gift under I.R.C. §2512. The couple, their four children and a child acting as trustee of the revocable trust executed a document providing that the couple transferred individual policies on each of their lives to the trust in exchange for a deferred payment note. The document further explained that the couple intended for the policies to be exchanged for a second to die policy issued in the name of the trustee. Although the couple directed the life insurance agent to issue the second to die policy in the name of the trustee only, the trustee erred and issued the policy in the names of the couple individually. Several months later, the couple forgave the deferred payment note without any payments having been made. The couple then sought to reform the policy to clarify that the trust was the owner and executed an assignment.

The Internal Revenue Service determined that the "intent facts" control rather than the "policy facts". The intent of the parties regarding the ownership of the policy was set forth in the documents executed contemporaneously with the transfer, accordingly, the Internal Revenue Service concluded that the reformation and assignment of the policy to reflect the trust as the owner would not constitute a transfer subject to gift tax. Furthermore, the Internal Revenue Service determined that the policy proceeds would not be includable in either the spouse's gross estate if either spouse died within three years of the reformation and the assignment under I.R.C. §2035

5. *Temple v. United States, 423 F.Supp.2d 605 (E.D. Tex. 2006)*

A donor and his deceased wife's estate were entitled to a gift tax refund plus interest of over $7,000,000 after the value of the transferred interest in four separate entities was determined. After the decedent and his spouse created three limited partnerships and a limited liability company, various gifts were made. Upon audit, the Internal Revenue Service increased the value of the gifts and the couple paid the additional assessed gift tax. The donors then sought a federal gift tax refund of approximately $5,847,000. After arriving at the net asset value of the various entities, the Court concluded that a 33% combined lack of marketability and lack of control discount plus an additional 7.5% incremental lack of marketability discount was applicable to the Ladera Land Limited Partnership. The Court additionally allowed a 60% discount for the Bogi Slough Limited Liability Company and a 33% combined lack of marketability and loss of control discount and a 7.5% incremental lack of marketability discount to a 1.6% Bogi Slough interest gifted to the decedent's grandchildren. The Court also determined that a discount for built-in capital gains with respect to the interest of both of the entities was inappropriate because an economically rational partnership and buyer would negotiate a I.R.C. §754 election. The Court allowed smaller minority interest discounts with respect to the family

partnership holding publicly-traded stock. The discounts for three separate gifts were 7.5%, 10.1% and 3.3% respectively.

E. Gifts by Husband or Wife to Third Party (I.R.C. §2513)

Priv. Ltr. Rul. 200616022 (April 21, 2006)

Because a wife's interest in a trust is susceptible of determination and is severable from gifts to other beneficiaries, the couple's gifts to trust are eligible for gifts splitting. The husband established an irrevocable trust with his wife as a contingent beneficiary if she survived the husband. The husband died within three years of trust creation and all of a portion of the trust assets were includable in his gross estate. The Internal Revenue Service found that although the wife had an interest as a contingent beneficiary, her interest was ascertainable and severable from gifts to the other beneficiaries and therefore, gift splitting was permissible.

F. Disclaimers (I.R.C. §2518)

1. *Priv. Ltr. Rul. 200521033 (May 27, 2005)*

When decedent died, he owned an individual retirement account (IRA) and had not yet attained his required beginning payment date under I.R.C. §401(a)(9)(C). Before he died, the decedent created two irrevocable trusts: a marital trust and a family trust. He then executed an IRA beneficiary designation designating the spouse as the primary beneficiary but if the spouse disclaimed, the marital trust would be the beneficiary of the disclaimed portion. The marital trust must pay its net income to spouse for life including the income from the IRA. The spouse will not only make a disclaimer of a fractional interest in the IRA and will also execute a separate disclaimer of her entire interest in the marital trust. The Internal Revenue Service has noted that as a result of the spouse's disclaimers, the disclaimed portion of the IRA will pass to the family trust, and that the spouse can make a qualified disclaimer with respect to the various interests.

2. *Priv. Ltr. Rul. 200522012 (June 3, 2005)*

This Letter Ruling is identical to Priv. Ltr. Rul. 200521033 discussed above.

3. *Priv. Ltr. Rul. 200530002 (June 29, 2005)*

A beneficiary renunciation of a one-fifth remainder interest in a trust created prior to January 1, 1977 constituted a taxable gift. The beneficiary's renunciation of the one-fifth remainder interest constituted a taxable gift under Treas. Reg. §25.2511-1(c)(2) because (1) the renunciation was not made within a reasonable time after the beneficiary learned of the interest; and (2) by accepting the trust income since the interest began the beneficiary accepted the benefit of the entire corpus.

4. *Priv. Ltr. Rul. 200530004 (July 29, 2005)*

The beneficiary's disclaimer of a remainder interest in a trust was not a taxable gift because the disclaimer was made within a reasonable time after the beneficiary learned of her interest. A trust was created for the lifetime benefit of the beneficiary's father pursuant to the will of the beneficiary's grandfather who died before January 1, 1977. Upon the death of her father, the trust terminated and the principal became distributable in equal shares to the beneficiary and her three siblings. The beneficiary claimed that she had no knowledge of the trust and had never seen her grandfather's will prior to the death of her father. In the case of transfers creating an interest in property made before January 1, 1977, Treas. Reg. §25.2511(c)(2) provides that a refusal to accept ownership of property is not treating as the making of a gift if the refusal is made within a reasonable time after knowledge of the existence of the transfer. Here, the beneficiary's disclaimer was made within nine months of learning of the existence of the trust which was considered a reasonable time.

5. *Priv. Ltr. Rul. 200616041 (April 21, 2006)*

A disclaimer of an interest in a decedent's individual retirement account made on behalf of the decedent's wife was a qualified disclaimer under I.R.C. §2518(b). Shortly after the decedent died, the wife also died. Within nine months of the decedent's death, the wife's personal representative disclaimed any interest the wife or her estate had in the IRA. The Internal Revenue Service noted that the disclaimer was in writing and delivered within nine months of the decedent's death and that the wife did not accept any of the disclaimed interest. Therefore, the disclaimer constituted a qualified disclaimer and the wife would be treated as predeceasing the decedent.

6. *Priv. Ltr. Rul. 200616026 (April 21, 2006)*

The decedent 's will provided that the residue of his estate passes to his surviving descendants in trust or if there are no surviving descendants, to a private foundation. One of the beneficiaries of the trust proposes to disclaim all of his beneficial interest. Prior to the beneficiary's execution of his disclaimer, the directors of the foundation amended its bylaws to provide that the property passing to the foundation pursuant to the beneficiary's disclaimer will be maintained as a separate fund that is not co-mingled with other property of the foundation. The taxpayer will not participate in any vote with regard to the management of the funds by the foundation. The Internal Revenue Service ruled that the disclaimer would be valid.

7. *Priv. Ltr. Rul. 200618017 (May 5, 2006)*

A disclaimer of an interest in residential rental properties, certificates of deposit and half of financial accounts qualifies. The decedent's residuary estate included residential property, two certificates of deposit and two financial accounts held in joint tenancy with right of survivorship by decedent and his spouse. Within nine months of decedent's death, the spouse filed a disclaimer with the court with respect to any interest she had under decedent's

will, in the property, the certificates of deposit and one-half of the financial accounts. The Internal Revenue Service noted that the disclaimer is valid because the spouse did not contributed to any of the joint accounts and did not accept any benefits including any income earned after decedent's death attributable to the property being disclaimed.

G. Disposition of Certain Life Estates (I.R.C. §2519)

1. *Priv. Ltr. Rul. 200530014 (July 29, 2005)*

A decedent created a trust that provides payments and distributions for his surviving spouse through a marital trust which qualifies for a qualified terminable interest property (QTIP) election. The surviving spouse proposes to divide the marital trust into two separate trusts. After the severance, the spouse will renounce her entire interest in one trust and will waive her right to recovery under I.R.C. §2207A(b) for gift taxes paid as a result of the renunciation. The Internal Revenue Service has found that after the severance, both trusts will qualify as QTIP trusts. When the spouse renounces her qualified income interest under §2519, she will be deemed to have made a transfer of all of the trust property other than her qualified income interest in the property. Thus, she is treated as making a gift of the fair market value of the trust reduced by the value of the qualified income interest and further reduced by the amount that the spouse is entitled to recover under I.R.C. §2207A(b). The Internal Revenue Service also ruled that the spouse's renunciation of her qualified income interest is a taxable gift under I.R.C. §2511 and that the waiver of the right to recover under I.R.C. §2207A(b) is a gift. Thus, the surviving spouse will be treated as having made a gift of the remainder interest, the qualified income interest and the right of recovery of gift taxes paid.

2. *Priv. Ltr. Rul. 200604006 (January 27, 2006)*

A non-qualified disclaimer of an entire interest in a qualified terminable interest property trust results in gifts under I.R.C. §§2519 and 2511. The decedent and his

spouse created a family trust funded with community property. At the time of the decedent's death, the family trust is divided into a decedent share and the survivor share with half of the community property allocated to each. The family trust provides that the residue of the decedent share is to be distributed to the marital trust and the entire net income of the marital trust will be paid to the surviving spouse at least quarterly. The surviving spouse plans to execute an irrevocable disclaimer of the surviving spouse's entire interest in the marital trust but the disclaimer will not be a qualified disclaimer under I.R.C. §2518 and so will be subject to gift tax. The Internal Revenue Service concluded that since the spouse's disclaimer is not a qualified disclaimer under I.R.C. §2518, the spouse's disclaimer of the spouse's entire interest in the marital trust is a disposition of the spouse's qualifying income interest and the amount of the gift made by the spouse is equal to the fair market value of the entire property that is subject to the qualified income interest determined at the time of disposition.

V. FEDERAL CASES AND RULINGS – GENERATION-SKIPPING TRANSFER TAX

A. Tax Imposed (I.R.C. §2601)

1. *Priv. Ltr. Rul. 200525003 (June 24, 2005)*

The division of an irrevocable trust into four subtrusts did not subject the trust assets to generation-skipping transfer (GST), gift or income taxes. The grantor created an irrevocable trust prior to September 25, 1985 for the benefit of her four grandchildren and their lineal descendants. A state court issued an order dividing the trust on a pro-rata basis into four subtrusts, one for each of the grantor's grandchildren with the same terms as the original trust except with regard to distributions to beneficiaries. The Internal Revenue Service concluded that the original trust did not lose its GST tax exempt status because the requirements of Treas. Reg. §26.2601-1(b)(4)(i)(D) were satisfied. The division (1) did not shift a beneficial interest in the

trust to any beneficiary who occupied a lower generation then the person or persons who held the beneficial interest prior the division, and (2) did not extend the time for vesting of any beneficial interest in the trust provided for in the original trust.

2. *Priv. Ltr. Rul. 200527008 (July 8, 2005)*

The reformation of a trust that was exempt from generation-skipping transfer (GST) tax because the grantors had allocated a sufficient amount of GST exemption to the trust to result in an inclusion ratio of zero did not alter the exempt status of the trust. Subsequent to September 25, 1985, the grantors created an irrevocable trust for the benefit of their children and their descendants. Once funded, the trust was divided into GST tax exempt and non-tax exempt shares. The grantors filed federal gift tax returns and each allocated an amount of the GST exemption to the exempt trust to result in an inclusion ratio of zero. Subsequently, the trust instrument was reformed to correct a scrivener's error to provide that the trust income and principal would be paid to a trust established by the grantors' relative only if there were no living issue of the grantors that could receive trust distributions. Although guidance has been provided for a trust that was created prior to September 25, 2985, similar guidance has not been issued concerning the effect of a modification on the status of a trust that was GST tax exempt because a sufficient amount of the GST exemption has been allocated. The Internal Revenue Service concluded that a change that would not alter the exempt status of a grandfather trust should not affect the exempt status of a trust within an inclusion ratio of zero.

3. *Priv. Ltr. Rul. 200532024 (August 12, 2005)*

The renunciation of a trust interest constituted a constructive addition to a generation-skipping transfer (GST) tax exempt trust. Prior to September 25, 1985, a trust for the benefit of the grantor's grandchildren and great-grandchildren was modified. Pursuant to Court order, the grandchildren would receive a certain sum each month and the remaining trust assets

were not distributed to the great-grandchildren but the remaining net income was distributed among the great-grandchildren. When the first of the grandchildren died, one-half of the trust principal was to be distributed equally among the great-grandchildren. The grandchildren proposed to renounce their interest in the trust resulting in the termination of the trust and the acceleration of distribution of the remaining trust principal to the great-grandchildren. By refusing to accept the trust payments that each grandchild was otherwise be entitled to receive, the Internal Revenue Service concluded that each grandchild was considered to have made a constructive addition to the trust equal in value to the amount of each of the grandchildren's renounced interest similar to the illustration contained in Treas. Reg. §26.2601-1(b)(1)(v)(D), *example one*. Therefore, because of the grandchildren's renunciation, a resulting pro-rata portion of the trust was subject to the GST tax.

4. *Priv. Ltr. Rul. 200540004 (October 7, 2005)*

A beneficiary's failure to exercise a right to withdraw amounts from the balance of a trust that was irrevocable on September 25, 1985 was not a constructive addition to the trust for generation-skipping tax purposes under I.R.C. §2601. The trust instrument provided that the beneficiary possessed a limited power of appointment over the trust principal in favor of the beneficiary's issue. Beginning at a specified age, the beneficiary also had a cumulative right of withdrawal with respect to the balance of the trust. The Internal Revenue Service ruled that the beneficiary's lifetime power to withdraw amounts from the trust principal was a general power of appointment with respect to the trust. Thus, upon the beneficiary's death, the lifetime power to withdraw would lapse and any amounts subject to the beneficiary's withdrawal right at the time of death would be included in the beneficiary's gross estate pursuant to I.R.C. §2041. As a result, for generation-skipping transfer tax purposes, the beneficiary would become the transferor and thus, the beneficiary did not make a constructive addition to the trust.

5. *Priv. Ltr. Rul. 200543015 (October 28, 2005)*

The implementation of a court-approved settlement agreement that modified the terms of the trust did not cause the trust to lose its grandfathered exemption from the generation-skipping transfer tax. The trust created for the benefit of the grantor's children, their spouses and descendants was irrevocable prior to September 25, 1985. On the death of the last to survive of the grantor's four children and 11 named grandchildren, the trust would terminate. An ongoing controversy existed among the beneficiaries regarding whether one of the grandchildren was actually the descendant of one of the grantor's children. After extensive negotiations, the parties reached a settlement that provided for a cash distribution to the grandchild and a distribution of a specified amount of stock to a trust for the benefit of the grandchild's descendants. The settlement agreement was approved by the State Court pending a favorable Internal Revenue Service ruling. The Internal Revenue Service found that the settlement agreement did not cause the trust to lose its generation-skipping tax exempt status because: (1) a bona fide issue existing regarding the status of the grandchild and her descendants; (2) the agreement was the result of arms-length negotiations; and (3) the settlement was within the range of reasonable outcomes under the governing instrument and applicable state law.

6. *Priv. Ltr. Rul. 200609003 (March 3, 2006)*

A conversion of income interests in two trusts to unitrust interests pursuant to applicable state law would not cause the trusts to lose their generation-skipping transfer (GST) tax-exempt status. The grantor created five separate trusts before September 25, 1985 to which no additions were made after that date. The grantor's daughter and her issue were beneficiaries of two of the trusts. After the daughter died, a new state law was enacted that authorized trustees to make equitable adjustments between trust income and principal and to

convert eligible trusts to unitrusts for purposes of determining trust income. The trustees sought a court order converting the income interest to a unitrust interest and the trustees requested a ruling that the conversion would not have adverse GST tax consequences. The Internal Revenue Service concluded that the conversion would not cause the trusts to lose their GST tax exempt status because (1) the conversion did not shift the beneficial interest in the trust to any beneficiary who occupies a lower generation and (2) the conversion would not extend the time for vesting any beneficial interest in the trust beyond the period provided in the original trust.

B. Taxable Amount in Case of Taxable Distribution (I.R.C. §2621)

Robertson v. United States, 2006 WL 302302 (N.D. Tex. 2006)

The taxable amount was determined under I.R.C. §2621 in the case of taxable distributions from four charitable lead non-exempt trusts. The grantor, who was the husband of the beneficiary's grandmother, established one trust for the benefit of each of the grandmother's four grandchildren. The trusts each contributed assets to a family partnership in exchange for a limited partnership interests. On December 13, 2002, each trust distributed substantial all of its assets to its respective remainder beneficiaries and each beneficiary filed a generation-skipping transfer tax return for distributions reporting $6,210,628 in trust distributions from their respective trusts. The Internal Revenue Service increased the value of the distributed assets and claimed that each beneficiary should have reported $9,640,977 in trust distributions. To compute the taxable amount under I.R.C. §2621, the Court first determined the value of the limited partnership interest. The Court then ruled that a 19% lack of control discount was applicable. A 12.5% discount for lack of marketability was also allowed. Therefore, the I.R.C. §2624 fair market value distributed to each beneficiary was $6,628,268. The Court also ruled that the beneficiaries were entitled to deduct attorney, appraisal and accounting fees in determining the GST taxable amount.

C. Allocation of Generation-Skipping Transfer Tax Exemption (I.R.C. §2632)

1. *Priv. Ltr. Rul. 200550006 (December 16, 2005)*

The information contained on a decedent's federal gift tax return constituted substantial compliance with the requirements of I.R.C. §2632 and Treas. Reg. §26.2632-1(b) for making a timely allocation of the decedent's available generation-skipping transfer (GST) tax exemption. Although the accounting firm hired to file the gift tax return correctly reported the necessary information, it misidentified the donee of the gift on Schedule C of the gift tax return and the notice of allocation. According to the Internal Revenue Service, so long as the information provided on the return was sufficient to indicate that a taxpayer intended to make an allocation, a donor would be deemed to have substantially comply.

2. *Priv. Ltr. Rul. 200613006 (March 31, 2006)*

A grantor was given a 60-day extension of time to elect out of the automatic allocation of the generation-skipping transfer (GST) exemption under I.R.C. §2632(c)(5) with respect to a transfer to a qualified personal residence trust (QPRT). At the time the grantor transferred a one-half interest in her residence to a QPRT, the law firm hired by the grantor prepared her federal estate tax return and no GST exemption was allocated. The grantor did not intend to allocate any of her available GST exemption and the existing law at the time of the transfer did not provide for automatic allocation. As a result of an amendment to I.R.C. §2632, the grantor's GST exemption was automatically allocated. In accordance with I.R.C. §2642(g)(1)(B), the grantor's request for an extension of time to make the election out of the automatic allocation was granted because the requirements of Treas. Reg. §301.9100-3 were satisfied since the grantor acted reasonably and in good faith and the interest of the government would not be prejudiced.

3. *Priv. Ltr. Rul. 200606002 (February 10, 2006)*

A husband and wife were granted an extension of time to allocate their generation-skipping (GST) exemption to the transfer of community property to an irrevocable trust. The couple created the trust for the benefit of the descendants of their two children and did not file gift tax returns after contributing property to the trust. The attorney who assisted with the preparation of the trust agreement did not advise the couple about the need to file gift tax returns allocating the GST exemption. After the death of the attorney, the failure to allocate the GST exemption was discovered. The couple requested an extension of time to file under Reg. §301.9100-3 and the Internal Revenue Service concluded that the requirements of the regulation were satisfied because (1) the couple acted reasonably and in good faith in relying on their attorneys; and (2) the granted relief would not prejudice the interest of the government.

D. Relief From Late Allocations of Exemption (I.R.C. §2642(g)(1))

Priv. Ltr. Rul. 200538023 (September 23, 2005)

A husband and the representative of his deceased wife's estate were granted extensions of time to allocate the generation-skipping transfer (GST) tax exemption to transfers made to two trusts. Each spouse created a trust and made gifts of life insurance policies on their own lives to their respective trusts. The tax professionals relied upon by the couple inadvertently failed to properly allocate each spouse's GST exemption to the transfers to the trusts. In accordance with I.R.C. §2642(g)(1)(B) and Notice 2001-50, 2001-2 C.B. 189, the request for an extension of time to allocate the GST exemption was governed by Treas. Reg. §301.9100-3. The Internal Revenue Service concluded that the requirements of Treas. Reg. §301.9100-3 were satisfied because the couple in relying on qualified tax professionals acted reasonably and in good faith and granting relief would not prejudice the interest of the government.

E. Inclusion Ratio (I.R.C. §2642)

Priv. Ltr. Rul. 200542030 (October 21, 2005)

A donor and the donor's spouse were each granted a 60-day extension of time to allocate their respective generation-skipping transfer (GST) tax exemptions to transfers made during a three-year period to two trusts with GST potential. In accordance with I.R.C. §2642(g)(1)(B) and Notice 2001-50, 2001-2 CB 189, the couple's request for an extension of time to allocate their exemptions was governed by Treas. Reg. §301.9100-3 and the Internal Revenue Service concluded that the requirements were met because (1) the couple acted reasonably in good faith in relying on the advice of a qualified tax professional; and (2) granting the relief would not prejudice the interest of the government.

F. Severance of Trust (I.R.C. §2642(a)(3))

Priv. Ltr. Ruls. 200613001 and 200613002 (March 31, 2006)

The division of trusts constitutes a qualified severance. These two letter rulings dealing with three trusts established by a married couple are virtually identical. The couple established three trusts, each with generation-skipping transfer tax potential. The couple retained an accounting firm after transferring stock of a corporation to each trust to prepare a valuation of their gifts and their gift tax returns. On their gift tax returns, each spouse elected to split their gifts and each spouse allocated an amount of the spouse's §2631 generation-skipping transfer tax exemption equal to half of the value of the couple's combined gifts to the three trusts. The Internal Revenue Service later selected the couple's gift tax return for audit and after a settlement agreement, the value of the stock they transferred to the trust was increased. As a result, each trust has an inclusion ratio that is greater than zero. The trustees of the three trusts plan to sever each trust into an exempt and a non-exempt trust with beneficiaries and terms identical to those of the original trusts. The assets of each trust will be allocated on a fractional

basis so that the exempt trust will have an inclusion ratio of zero and the non-exempt trust will have an inclusion ratio of one. The Internal Revenue Service ruled that the proposed division will be a "qualified severance" within the meaning of I.R.C. §2642(a)(3).

G. Other Definition (I.R.C. §2652)

1. *Priv. Ltr. Rul. 200522002 (June 3, 2005)*

A decedent's estate was granted a 60-day extension of time to divide a qualified terminable interest property (QTIP) trust into an exempt and a non-exempt trust for generation-skipping transfer (GST) tax purposes and to make a reverse QTIP election with respect to the exempt trust. Although a QTIP election was made for the assets in the marital trust, the accountant hired by the estate failed to (1) advise the executor to sever the marital trust into an exempt and non-exempt trust; (2) make the reverse QTIP election for the GST tax-exempt trust; and (3) allocate the decedent's available GST tax exemption. The Internal Revenue Service determined that the requirements of Treas. Reg. §301.9100-3 were satisfied concluding that the estate acted reasonably and in good faith by relying on a qualified tax professional who failed to make the election and granting relief would not prejudice the government's interest.

2. *Priv. Ltr. Rul. 200548017 (December 2, 2005)*

A decedent's estate was granted a 60-day extension of time to make a reverse qualified terminable interest property (QTIP) election under I.R.C. §2652(a)(3) with respect to a marital trust. The Internal Revenue Service concluded that the requirements of Treas. Reg. §301.9100-1 and Treas. Reg. §301.9100-3 were satisfied because the estate acted reasonably and in good faith in relying on the advice of a qualified professional and granting relief would not prejudice the interest of the government.

H. Trusts Created as Separate Trusts (I.R.C. §2654(b))

Priv. Ltr. Rul. 200543037 (October 28, 2005)

The Internal Revenue Service will give effect to a court order making the non-exempt marital trust liable for all federal estate tax payable by either the exempt or the non-exempt trust. The decedent's will created a marital trust, the property of which was to be used to pay death taxes owed by the surviving spouse's estate due to the inclusion of the marital trust in the surviving spouse's estate pursuant to I.R.C. §2044. A court ordered the partition of the marital trust into a GST exempt marital trust and a GST non-exempt marital trust. The Court also ordered all death taxes attributable to the two trusts be paid from GST non-exempt marital trust. Citing Commissioner v. Estate of Bosch, 387 U.S. 456 (1967), the Internal Revenue Service ruled that it will give effect to the Court's order construing the surviving spouse's will.

VI. FEDERAL CASES AND RULINGS – SPECIAL VALUATION RULES

A. Special Valuation Rules in Case of Transfers of Interest in Trust (I.R.C. §2702)

1. *Estate of Focardi v. Commissioner, T.C. Memo. 2006-56*

Revocable spousal interests in four separate grantor retained annuity trust (GRATs) created by a husband and wife were not qualified interests for the purposes of I.R.C. §2702. On October 25, 1996, the husband and wife transferred shares of corporation stock to four separate GRATs, each of which included a two-year and a four-year term GRAT for each grantor. The couple filed a federal gift tax return and the value of the gifts was calculated by actuarially utilizing the value of two-life annuities under I.R.C. §7520. The Internal Revenue Service determined that the couple's gift tax should have been calculated by reducing the value of the shares by the value of a single-life annuity. The Court concluded that the spousal interests were not I.R.C. §2702 qualified interest because (1) the spousal interests were contingent on the

grantor's failing to survive the applicable two or four-year period and (2) the spousal interests were not payable for the life of the term holder, for a term of years or for the shorter of these periods.

2. *Priv. Ltr. Rul. 200617035 (April 28, 2006)*

Two parcels of land improved by a residence, bath house and pavilion and encumbered by a conservation easement constitute a personal residence within the meaning of I.R.C. §2702(a)(3). The property is used solely as the grantor's vacation home, no commercial activity is conducted on the property and the property is located on an island that is agricultural, rural and sparsely populated. Prior to the transfer of the property to a qualified personal residence trust, the settlor placed a qualified conservation easement on the property.

B. Certain Rights and Restrictions Disregarded (I.R.C. §2703)

Estate of Amlie, T.C. Memo. 2006-76

The Tax Court has held that a buy-sell agreement fixed the estate tax value of closely-held stock because it met the requirements of I.R.C. §2703 and Tress. Reg. §20.2031-2(h). The Court and found that the agreement met the pre-I.R.C. §2703 requirements because (1) the price was fixed determinable, as the agreement restricted the value of all of the decedent's stock and (2) the agreement was legally binding upon the decedent's life and after her death as the agreement was court approved. The Court also determined that the agreement would not be disregarded under I.R.C. §2703(a) because the requirements of I.R.C. §2703(b) were satisfied. Specifically, the Court ruled that the buy-sell agreement: (1) furthered a business purpose by securing a guaranteed price for the decedent's minority interest; (2) was not a testamentary device to transfer property to the decedent's family members at a price for less than full and adequate consideration because the decedent received a fixed price for a minority interest; and

(3) was comparable to a similar arms-length arrangement because the price was originally reached in a 1994 agreement and was based on a survey of comparable transactions.

VII. FEDERAL CASES AND RULINGS – INCOME TAX AND MISCELLANEOUS

A. Gross Income Defined (I.R.C. §61)

1. *Chief Counsel Adv. 200608038 (February 24, 2006)*

The Internal Revenue Service has ruled that the rights afforded domestic partners under the California Act creating rights among domestic partners are not "made an incident of marriage by the inveterate policy of the state" and consequently, the National Office concluded that an individual who is a registered domestic partner in California must report all of his or her income earned from the performance of personal services and may not split the income with his or her domestic partner.

2. *Lattera v. Commissioner, 437 F.3d 399 (3rd Cir. 2006)*

Lump sum consideration paid to taxpayers in exchange for their right to receive future lottery payments is ordinary income rather than capital gains because the payments are made for the future right to earned income rather than the future right to earn income.

3. *Watkins v. Commissioner, 447 F.3d 1269 (10th Cir. 2006)*

A lump sum payment in exchange for future installments of lottery winnings is taxable as ordinary income rather than capital gains. On May 1, 1993, the taxpayer won $12,358,688 from the Colorado State Lottery payable in 25 annual installments through an annuity purchased by the Colorado State Lottery. The taxpayer reported the receipt of his first six prize payments as ordinary income. After a divorce in which the taxpayer and his wife each received a one-half interest in future lottery payments, the taxpayer entered into a contract in consideration of which the taxpayer assigned his rights to future payments and received

$2,614,744. The taxpayer treated this payment as capital gain with a cost basis of zero. However, the Internal Revenue Service did not agree holding that under the "substitute for ordinary income doctrine" the lump sum payment should be taxed as ordinary income.

B. Two Percent Floor on Miscellaneous Itemized Deductions (I.R.C. §67)

Rudkin Testamentary Trust v. Commissioner, 124 T.C. No. 19 (2005)

The Tax Court has once again held that the investment advisory fees paid by a trust were deductible only to the extent that they exceeded 2% of the trust's adjusted gross income. In reaching this result, the Court determined that the expenses did not qualify for the exception in I.R.C. §67(e)(1) under which costs paid or incurred in connection with the administration of a trust that would not have been incurred if the property were not held in trust are allowed in full as deductions in arriving as gross income. The Rudkin family was involved in the founding of Pepperidge Farm that was sold to Campbell's Soup Company in the 1960's. The trust was initially funded with proceeds from that sale and was set up to benefit Henry Rudkin's son, William and his spouse and descendants. The trustee had broad authority to manage and invest trust funds and in exercising that authority, the trustee paid Warfield Associates, Inc. $22,241 for investment advisory services during the trust 2000 tax year.

C. Exclusion of Life Insurance Proceeds (I.R.C. §101(a))

Priv. Ltr. Rul. 200606027 (February 10, 2006)

"Transfer for Value" rule of I.R.C. §101(a)(2) does not apply to exchange of life insurance policies since exchange is disregarded. The taxpayer created one trust for the benefit of his children and his spouse and a second trust for the benefit of the grandchildren of the taxpayer and the taxpayer's spouse. The trustee of one trust plans to exchange two policies with the trustee of the second trust in exchange for two other policies. The two trusts are grantor

trusts under I.R.C. §671. The exchange of the life insurance policies will be disregarded for federal income tax purposes.

D. Exclusion of Gain from Sale of Principal Residence (I.R.C. §121)

1. *Priv. Ltr. Rul. 200613009 (March 31, 2006)*

A delay caused by the complexity of an adoption procedure constitutes "unforeseen circumstances" for purposes of the I.R.C. §121(c) reduced maximum exclusion. The taxpayer moved from his initial principal residence in order to comply with certain state requirements pertaining to the adoption of a foreign child. The Internal Revenue Service ruled that the primary reason for the taxpayer's sale of their initial residence was an unforeseen circumstance within the meaning of I.R.C. §121(c) and thus, the taxpayer is entitled to a reduced maximum exclusion of gain.

2. *Priv. Ltr. Rul. 200615011 (April 14, 2006)*

A move caused by a threat to a police officer and his family constitutes "unforeseen circumstances" for purposes of the I.R.C. §121(c) reduced maximum exclusion. Taxpayer works as a narcotics investigator for the street crime unit of a City Police Department. After taxpayer conducted a highly-publicized arrest of an alleged drug dealer, the City Police Department learned that associates of the arrested drug dealer had discovered taxpayer's home and planed to kill taxpayer in his home. Because taxpayer feared for the safety of himself and his family, the family moved and sold the house. On the date of sale, the taxpayer had not owned and used the property as the principal residence for two years during the five-year period preceding the sale. However, the Internal Revenue Service ruled that the primary reason for taxpayer's sale was a "unforeseen circumstance" and thus, taxpayer was entitled to a reduced maximum exclusion of gain under I.R.C. §121(c).

E. Charitable Contributions and Gifts (I.R.C. §170)

Koblick v. Commissioner, T.C. Memo. 2006-63

The fair market value of a married couple's contribution of stock to a charitable foundation was determined and a deficiency assessed based on the Internal Revenue Service calculations of value. The value of the stock was significantly less than the amount reported by the taxpayer and in addition, a 10% minority interest discount was applied.

F. Individual Retirement Accounts (I.R.C. §408)

1. *Millard v. Commissioner , T.C. Memo. 2005-192*

Taxpayer's 2001 gross income includes the amount of a check taxpayer received as an IRA distribution but did not cash in 2001. In 2001, the taxpayer initiated closure of his IRA and the custodian issued the taxpayer a check in the amount of $10,841.06 dated May 10, 2001. The taxpayer, however, did not present the original check to the custodian for payment until March 21, 2003. The Court concludes that taxpayer's 2001 gross income includes the amount of the check he received even though he did not endorse it in that year. A cash method taxpayer constructively receives income as of the date that a check is received absent a substantial limitation. Here, the record shows that the original check was not subject to any substantial limitations and the taxpayer makes no contention otherwise.

2. *Rev. Rul. 2005-36, 2005-26 I.R.B. 1368 (June 27, 2005)*

The Internal Revenue Service has ruled that where a beneficiary disclaims an interest in a decedent's Individual Retirement Account (IRA), the disclaimer is qualified under I.R.C. §2518 even though the disclaimant received the required minimum distribution from the IRA for the year of the decedent's death. The Internal Revenue Service ruled that the disclaimant's receipt of the required minimum distribution for the year of the decedent's death does not preclude a disclaimer of the IRA's remaining balance so long as no benefit from the disclaimed amount is accepted by the disclaimant either before or after the disclaimer. However,

the Internal Revenue Service noted that a qualified disclaimer is not permitted for the income attributable to the required minimum distribution. Specifically, the Internal Revenue Service concluded that a disclaimer can be made if, when the disclaimer is made, the beneficiary entitled to receive the disclaimed amount is paid the disclaimed amount and the income attributable to such amount or such amounts are segregated in a separate fund. A disclaimant who disclaims all the remaining balance in an IRA is not considered a designated beneficiary of the IRA within the meaning of I.R.C. §401(a)(9) if the qualified disclaimer is made before September 30th of the calendar year following the calendar year of the employee's death and if on or before September 30th the beneficiary is paid the income attributable to the minimum distribution.

3. *Priv. Ltr. Rul. 200617037 (April 28, 2006)*

This letter ruling points out an option available to a qualified plan distribution to a participant who takes out a loan and subsequently rolls the qualified plan proceeds into an IRA. Normally, the taxpayer cannot borrow from an IRA and thus, must either treat the loan as distributed to the taxpayer and pay tax on it or pay the loan back. This letter ruling allows the taxpayer 60 days from the date of the distribution to roll over the amount of the loan by payment to an IRA and avoid payment of tax.

4. As in the past, there are numerous rulings granting the waiver of the 60-day roll over requirement of I.R.C. §408(b)(3)(l), however, rulings for which the waiver is denied are instructive:

a. *Priv. Ltr. Rul. 200526024 (July 1, 2005)*

Waiver of the 60-day time limit was denied where the taxpayer failed to realize the tax consequences of donating the withdrawn amount to charities. The taxpayer apparently withdrew an amount from his individual retirement account and donated the amount to charities in return for an annuity. Only when the taxpayer filed his 2003 federal

income tax return did he realize that the withdrawal constituted taxable income. At that point, the 60-day time limit for a rollover had expired. The Internal Revenue Service found that the taxpayer did not make a timely rollover because he donated almost all of the withdrawn amount to charities.

b. *Priv. Ltr. Rul. 200530032 (July 29, 2005)*

Waiver of the 60-day time limit cannot be granted because the IRA proceeds have been transferred to a trust not owned by the taxpayer. Apparently, the taxpayer withdrew funds from his IRA and deposited the distributions into a trust of which another person was the grantor with a trust company as the trustee. The taxpayer was not aware that he was required to withdraw the entire proceeds or that after having withdrawn these amounts, he could then roll them over to an IRA established in his own name within 60-days. The taxpayer is an elderly man and English is not his native language. Nonetheless, the Internal Revenue Service has ruled that it can waive the time limit for an IRA rollover only where the distribution for which the extension is requested is eligible for rollover treatment. Since the proceeds are in a trust, not created by the taxpayer, the Internal Revenue Service found that it could not grant the waiver.

c. *Priv. Ltr. Rul. 200534026 (August 26, 2005)*

The Internal Revenue Service has ruled that a pro-rata portion of the amount recovered for alleged mismanagement of a taxpayer's IRA and non-IRA funds could be rolled over tax free to another IRA. Under the terms of a settlement agreement, two management companies sent checks in an unspecified amount to the taxpayer's attorney. The agreement did not indicate what portion of the amount represented IRA losses versus non-IRA losses. The Internal Revenue Service concluded that the amount rolled over into the taxpayer's new IRA represented a valid roll over since the settlement proceeds were designated to replace a

portion the taxpayer's IRA and non-IRA due to the alleged misconduct on the part of the management companies. It was appropriate to allocate a pro-rata portion of the total settlement less attorneys' fees and the expenses.

d. *Priv. Ltr. Ruls. 200540020 and 200540024 (October 7, 2005)*

Waiver of the 60-day time limit of I.R.C. §402(c) for roll over denied for taxpayer who received proceeds of his wife's annuity contract before she died. Because the taxpayer was not treated as receiving the proceeds as a surviving spouse, the amount was not a qualified distribution eligible for roll over under I.R.C. §402(c)(3).

e. *Priv. Ltr. Rul. 200540023 (October 7, 2005)*

The Internal Revenue Service declined to waive the 60-day roll over requirement despite taxpayer's distraction over her child's neurological disability. The IRA withdrawal predated the disability and taxpayer was able to keep track of other matters and engage in financial transactions such as the IRA withdrawal and subsequent purchase of beach property.

f. *Priv. Ltr. Rul. 200541050 (October 14, 2005)*

Waiver of the 60-day time limit for roll over denied where taxpayer was erroneously informed that he could borrow from his IRA. Apparently, the taxpayer's investment advisor advised the taxpayer that he could borrow money from his IRA to use towards the purchase of a new residence. After the withdrawal was made, the taxpayer learned that he could not borrow from his IRA. The Internal Revenue Service noted that use of an IRA distribution as a short-term loan is not consistent with the intent of congress in allowing the roll over.

g. *Priv. Ltr. Rul. 200544022 (November 4, 2005)*

Waiver of the 60-day time limit for roll over was denied where the taxpayer was prevented from completing the roll over by hurricane damage to his home in 2004. The Internal Revenue Service found that the taxpayer essentially used the IRA distribution as a short-term interest free loan.

h. *Priv. Ltr. Rul. 200544025 (November 4, 2005)*

Waiver of the 60-day time limit for a roll over denied to taxpayer who used IRA withdrawal as a short-term loan to satisfy divorce decree obligations.

i. *Priv. Ltr. Rul. 200544027 (November 4, 2005)*

Waiver of the 60-day time limit denied to taxpayer who mistakenly believed he was using the IRA withdrawal to invest IRA assets in real estate. The Internal Revenue Service explained that an individual cannot serve as a trustee of his own IRA and thus, could not invest IRA assets.

j. *Priv. Ltr. Rul. 200609022 (March 3, 2006)*

Waiver denied taxpayer who took IRA distribution to purchase a new home and failed to accomplish a timely rollover due to delay in sale of old home caused in part by a hurricane. The Internal Revenue Service found that the taxpayer used the IRA distribution in a transaction that in essence amounted to a short-term interest free loan.

k. *Priv. Ltr. Rul. 200609023 (March 3, 2006)*

Waiver denied where taxpayer failed to understand rollover rules and was upset by failing health of a close friend during the rollover period. The Internal Revenue Service noted that the taxpayer did not contact a tax professional to determine whether his understanding of the rollover rules was correct and that the ability to deposit the rollover amount in a rollover IRA was at all times within the taxpayer's control.

l. *Priv. Ltr. Rul. 200613037 (March 31, 2006)*

Waiver denied for a rollover into eligible plan under I.R.C. §402(c) where taxpayer failed to notify plan administrator of intended rollover. The Internal Revenue Service noted that the taxpayer did not provide any information evidencing a request to the administrator not to withhold for federal income tax purposes or to rollover the amount.

m. *Priv. Ltr. Rul. 200617039 (April 28, 2006)*

Waiver for rollover into eligible plan denied where taxpayer was given erroneous advice by employee of plan sponsor. The Internal Revenue Service reasoned that the taxpayer had no intent to rollover the plan distribution and that the erroneous advice did not concern a rollover. Rather, the taxpayer deliberately chose not to roll over the stock portion of his plan distribution.

n. *Priv. Ltr. Rul. 200618028 (May 5, 2006)*

Waiver of time limit denied where taxpayer asserted that medical condition and treatment prevented the timely rollover. The Internal Revenue Service concluded that the ability to roll over the amount was at all times within the taxpayer's control.

o. *Priv. Ltr. Rul. 200618030 (May 5, 2006)*

Waiver of time limit denied estate of widow despite incorrect advice estate received from its attorney because the estate was not eligible to make the rollover since the decedent was not the sole payee of the individual retirement account.

G. Special Rules for Credits and Deductions (I.R.C. §642)

Priv. Ltr. Rul. 200617001 (April 28, 2006)

A court ordered modification of a trust permits it to claim a charitable deduction for permanent set-asides of capital gains. Prior to the Court's modification, the decedent's will provided that the trustees have the right to decide what is income and what is principal. Thus, no charitable deduction would be allowed for amounts permanently set aside.

The will, as modified by the Court, provides that the trustees have the power to decide what is income and what is principal in accordance with the laws of the state in question and the estate's accounting rules. Furthermore, as modified, the will requires that all capital gains be assigned to trust principal and not income.

H. Deduction for Estates and Trusts Accumulating Income or Distributing Corpus (I.R.C. §661)

Priv. Ltr. Rul. 200536014 (September 9, 2005)

The Internal Revenue Service clarified the income tax consequences of the distribution of an annuity contract to the taxpayer by her former husband's estate by ruling that the transfer of the contract to the taxpayer pursuant to the divorce decree was not a distribution to a beneficiary under I.R.C. §661 but had to be included in income under I.R.C. §72 by the taxpayer. The Internal Revenue Service ruled that the distribution of the annuity to the taxpayer was not a distribution to a beneficiary under I.R.C. §661 because the taxpayer was not a beneficiary of the husband's estate but rather his creditor. The Internal Revenue Service then ruled that the transfer of annuity con

I. Trust Distribution Within Sixty-Five Days of Year End (I.R.C. §663(b))

Priv. Ltr. Rul. 200602009 (January 13, 2006)

The Internal Revenue Service has granted an extension of time to file the §663(b) election pursuant to Treas. Reg. §§301.9100-1 and 301.9100-3.

J. Charitable Remainder Trusts (I.R.C. §664)

1. *Priv. Ltr. Rul. 200524013 (June 17, 2005)*

Division of a charitable remainder unitrust does not disqualify trusts or resulting trusts under I.R.C. §664 or terminate the trust's private foundation status under I.R.C. §507. A husband and wife are the grantors and unitrust beneficiaries of a charitable remainder

unitrust. For various reasons, the husband and wife want to divide the trust into two separate charitable remainder trusts, one for the benefit of the husband and one for the benefit of the wife. Both trusts will be identical to the original trust except that the husband will be the only beneficiary of one trust and the wife will only be the only beneficiary of the second trust; each grantor will retain a survivorship interest in the other's unitrust payment. The Internal Revenue Service ruled that the division of the trust into two trusts will not cause any of the trusts to fail to qualify as a charitable remainder unitrust under I.R.C. §664(d).

2. *Priv. Ltr. Ruls. 200524014 (June 17, 2005) and 200525008 (June 24, 2005)*

Division of a net income make up charitable remainder unitrust (NIMCRUT) and contribution of one interest to a private foundation will not cause the remaining trust to cease to qualify under I.R.C. §664(d)(2). The taxpayer and taxpayer's wife are the founders and trustees and substantial contributors to a family foundation. Taxpayer intends to contribute an undivided portion of his interest in the charitable remainder unitrust to the family foundation. In order to accomplish, the taxpayer will divide the trust into two separate trusts. The Internal Revenue Service concludes that the division of the trust into two trusts and the contribution of one trust to the private foundation will not cause the remaining trust to be disqualified.

3. *Priv. Ltr. Rul. 200532022 (August 12, 2005)*

The taxpayers created a net income charitable remainder unitrust but were unaware that the trust did not contain language directing the trustee to allocate realized post-contribution capital gains to trust income. The trustee has administered the trust as though a provision allocating realized post-contribution capital gains to trust income had been included. Because the trust is irrevocable, the trustee sought a court order authorizing amendment of the

trust *ab initio*. The Internal Revenue Service ruled that the reformed trust will be treated as a valid charitable remainder unitrust under I.R.C. §664(d) *ab initio*.

4. *Priv. Ltr. Rul. 200539008 (September 30, 2005)*

The division of a charitable remainder unitrust pursuant to a divorce will not cause resulting trusts to fail to qualify under I.R.C. §664 or result in gain recognition. The assets of the trust were to be divided equally between the two trusts and each spouse will become sole trustee and income beneficiary of his or her separate trust. Each will have the right to designate the charitable beneficiaries of their respective trust. Furthermore, pursuant to I.R.C. §1041, no recognition of gain or loss will occur pursuant to the division.

5. *Priv. Ltr. Rul. 200617026 (April 28, 2006)*

Modification of trust to permit limited distributions to charitable beneficiary does not disqualify it as a charitable remainder trust. The trustee proposes to amend the trust to provide that after the beneficiary receives its annuity payment, the trustee may make annual distributions of principal to the charity. The Internal Revenue Service holds that this modification will not disqualify the charitable remainder annuity trust.

6. *Priv. Ltr. Rul. 200616008 (April 21, 2006)*

During their marriage, A and B established a charitable remainder annuity trust. The parties have divorced and pursuant to the marriage settlement agreement, the parties planned to divide the trust into two separate trusts, each containing 50% of the trust assets and with identical terms. The Internal Revenue Service has ruled that the division will not disqualify the charitable remainder trust.

K. Income in Respect of a Decedent (I.R.C. §691)

1. *Priv. Ltr. Rul. 200537019 (September 16, 2005)*

The excess of the value of an annuity contract over its basis in the decedent's hands received by the estate as beneficiary, is income in respect of the decedent. When decedent died, decedent owned a non-qualified annuity contract, with a value in excess of decedent's basis. The named beneficiary of the death benefit under the contract is the decedent's estate. The amount received on surrender of the contract will be distributed as part of the residuary bequest to 10 named charities. The estate must include the income as income in respect of the decedent and will be entitled to a charitable deduction under I.R.C. §642 for the income in respect of the paid to or set aside for the 10 named charities.

2. *Eberly v. Commissioner, T.C. Sum. Opinion 2006-46*

The Tax Court in a Summary Opinion has held that a distribution from an estate to a beneficiary derived from funds received by the estate from the decedent's retirement plan was not income in respect of the decedent because the retirement plan distribution was properly reportable on the decedent's final income tax return. While processing of the payment was not completed until after death, the decedent had, before he died, taken all steps required by the plan to receive the payment.

3. *Priv. Ltr. Rul. 200617020 (April 28, 2006) and Priv. Ltr. Rul. 200618023 (May 5, 2006)*

Assignment of an IRA to a charity in satisfaction of the charity's share of the decedent's residuary estate will not constitute transfer within the meaning of I.R.C. §69(a)(2) and therefore, cause adverse tax consequences to the estate.

L. Gain or Loss on Sale or Exchange (I.R.C. §1001)

1. *Priv. Ltr. Rul. 200540008 (October 7, 2005)*

Transfer of tenancy in common interest to daughter constitutes a sale or exchange to the extent of consideration received from daughter. The taxpayers received a 100% community property interest in real property from a trust and the property was encumbered with a recourse loan that is secured by a deed of trust. The taxpayers wish to give their daughter a gift of a 50% undivided tenancy in common interest in the property through a grant deed. The taxpayer will retain a 50% interest and will remain the sole obligors on the loan that encumbers the property. The daughter, however, will enter into a written contract with the taxpayers that will make her responsible for repaying one-half (1/2) of the loan principal balance. The Internal Revenue Service noted that the taxpayers will continue to be the sole obligors on the recourse loan that encumbers the property, but will receive the daughter's contractual obligation to repay half the principal balance. Thus, the taxpayers will be discharged from liability to that extent. The Internal Revenue Service ruled that the transfer of the 50% undivided tenancy in common interest in the property to the daughter will be treated as a sale or exchange to the extent of the amount of consideration that the taxpayers received. The balance of the value will be treated as a gift under I.R.C. §2511.

2. *Priv. Ltr. Rul. 200552009 (December 30, 2005)*

Merger of trust followed by division of surviving trust does not result in gain under I.R.C. §1001(a). The settlor initially established four trusts for the benefit of the issue of a one of his children. The trustees now propose a merger of the four trusts followed by a division of the surviving trust in order to meet the separate investment objectives of settlor's four children and their families. The Internal Revenue Service found that each beneficiary will have the same beneficial interest in each asset of each trust before and after the merger and that each interest in the new trust will be on substantially the same terms. Thus, the proposed merger and

the division will not result in a material difference in kind or extent of the legal entitlements and therefore, no gain or loss need be recognized.

M. Mitigation of Effect of Statute of Limitations (I.R.C. §1311-1314)

Malm v. United States, 420 F.Supp.2d 1040, (D. N.D. 2005)

Untimely claim filed by decedent's estate seeking refund of income tax that was overpaid as a result of court decision upholding Internal Revenue Service's higher valuation of decedent's stock is not entitled to relief under the mitigation provisions. When Henry Malm died on August 5, 1998, his estate included shares of Medtronic stock. The Internal Revenue Service disputed the estate's valuation with the result that the stock was increased in value for federal estate tax purposes. The estate ultimately filed a refund claim but the claim was barred by statute of limitations. The Court holds that the estate is not entitled to relief under the statute of limitations mitigation provisions of I.R.C. §1311-1314 because the estate does not satisfy two of the three requirements for application of the mitigation provisions. First, there is no "determination" as defined by I.R.C. §1313(a) and second, even assuming that a determination existed in the case, the determination is not of the specified circumstances of adjustment listed in I.R.C. §1312.

N. Collection After Assessment (I.R.C. §6502)

Bacigalupo v. United States, 399 F.Supp.2d 835 (M.D. Tenn. 2005)

James Bacigalupo died May 25, 2002. On May 20, 2004, the Internal Revenue Service filed a claim against the estate in the probate proceeding in a Tennessee State Court listing unpaid income taxes due and owing by the decedent for the years 1996-1999 and 2001-2002. The decedent's administrator denied the claim stating that the claim was filed more than 12 months after the decedent's death and was therefore, barred by the Tennessee statute setting a 12-month limitation period for filing claims against an estate. The Internal Revenue

Service removed the case to Federal District Court and on summary judgment, the Court held in favor of the government holding that the federal government is not bound by state statutes of limitations in enforcing its rights. Therefore, the federal 10-year statute of limitations set forth in I.R.C. §6502 applies.

O. Tax Refunds (I.R.C. §6512)

Estate of Smith v. Commissioner, 429 F.3d 533 (5th Cir. 2005)

After several years of litigation, the Tax Court entered a decision on January 24, 2002 holding that there was a $238,847.24 over payment of federal estate tax. The Commissioner, however, issued refunds to the estate which were less than the overpayment amount and interest thereon. The Commissioner alleged that the refund was less because after the Court's decision became final and pursuant to I.R.C. §6402(a), he applied $85,336.83 to assessed but unpaid interest that had accrued on the estate tax deficiency prior to the date of payment. The estate filed a motion to enforce the Tax Court's order regarding the overpayment and the Tax Court ruled in favor of the estate. The Fifth Circuit has reversed the Tax Court holding that the Tax Court erred in its initial holding that an overpayment determination necessarily decides any underpayment of interest due. Since the record reflects that the estate liability for underpayment of interest was not decided in determining the taxpayer's overpayment, the Tax Court exceeded its jurisdiction under I.R.C. §6512(b)(2) by ordering the Commissioner to refund the full amount of the overpayment.

VIII. CALIFORNIA DEVELOPMENTS

A. Senate Bill No. 555 (Chapter 264) Filed September 22, 2005

This Senate Bill amends Revenue and Taxation Code §63.1. Currently, the exclusion from reassessment for transfers between grandparents and grandchildren is unavailable when there is a living stepparent. The legislation provides that the existence of a

stepparent whose relationship to the grandparent in question is as a daughter-in-law or son-in-law does not disqualify the grandchild from receiving the change of ownership exclusion.

B. Senate Bill No. 565 (Chapter 416) Filed September 29, 2005

This Senate Bill amends Revenue and Taxation Code §62 to provide that beginning on January 1, 2006, a change of ownership does not include any transfer between registered domestic partners for California property tax assessment purposes. Transfers that will not trigger a reassessment include but are not limited to the following:

1. Transfers by gift or that take effect upon the death of a registered domestic partner;

2. Transfers to a registered domestic partner or former registered domestic partner in connection with a property settlement agreement or decree of dissolution of a registered domestic partnership or legal separation;

3. A creation, transfer or termination solely between registered domestic partners of any co-owners interest; and

4. Transfers to a trustee for the beneficial use of a registered domestic partner or the surviving registered domestic partner of a deceased transferor.